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Income Tax Decisions of 1949

By JACK SCHLOSSER, C.P.A.

IN this review of the income tax decisions of 1949, the writer has once again attempted, as in prior years, to select only those cases which were concerned with basic issues recurring in the practice of the average accountant and, therefore, of greatest practical significance.

Culbertson and Family Partnerships

The one decision which may conceivably affect the greatest number of practitioners and taxpayers is the Supreme Court's findings in the family partnership case of *Commissioner* v. *N. O. Culbertson, Sr.* (69 S. Ct. 1210; June 27, 1949). Briefly, the Court held that the Tax Court has been in error in its application of the *Tower* and *Lusthaus* doctrine. Vital servcies or original capital were not the *sole* determinants of a valid family partnership. Rather they were to be considered along with all the other facts and circumstances of the case to determine whether the parties in fact intended and achieved the formation of a bona fide partnership. Control over the income of the suspect partners was once again deemed a vital factor in this respect. Furthermore, it was held that in certain instances a gift could constitute original capital.

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The full signficance of the *Culbertson* decision has not yet been assayed. There are some practitioners who believe that the family partnership situation has reverted to the pre-*Tower* status where the sole determining factors required to be established were:

(a) The requirement of captial in the business.

(b) A completed gift of the partnership capital.

(c) Complete control by the donee over the partnership income.

While the writer is not yet inclined to agree completely with so optimistic a view, nevertheless it cannot be denied that the Courts have become increasingly liberal in their findings in family partnership cases. The following post-*Culbertson* decisions are of interest:

(1) Husband made a gift of stock in a closely-held corporation to his wife in 1938, at which time there was no intent to liquidate and form a partnership. In 1939, the corporation was liquidated and a partnership formed. The Tax Court held that the wife had contributed original capital despite its origin in a gift of stock.

(*Joseph Middlebrook, Jr.* v. *Commissioner*, 13 TC, No. 54; Sept. 27, 1949.)

(2) Where the entrance of wives into a family partnership was prompted by a need to bolster the credit status of the partnership, it was held a valid partnership existed despite the fact that the wives had received a portion of their capital as gifts from their husbands. Furthermore, gifts to the wives from a sister-in-law was held to be not within a close family group.

(*O. H. Delchamps* v. *Commissioner,* 13 TC, No. 39; August 30, 1949.)

(3) Where the nature of the business was such that the income emanated solely from capital and not from the services of the parent, a son was recognized as a partner despite the fact that:

(a) he was in the army when the partnership was formed and during the taxable years involved; hence he could not have rendered vital services.

(b) his capital originated either in gifts from his father made in prior years or in loans from his father repaid out of partnership profits.

(*John B. Atkins* v. *U. S.*, U. S. District Court; Western District of Louisiana: September 30, 1949.)

(4) In 1941, a husband and wife created three trusts for their children, conveying thereto stock in a closely-held corporation. The wife had previously received her stock as a gift from her husband in 1936. Later, in 1941, the corporation was dissolved and a limited partnership formed. It was held that both the wife and the three trusts were valid partners. In arriving at its decision, the court noted the following:

(a) The wife had received $125,000 as dividends from 1936-41; had deposited them in her own account; had used said income for her own purposes; and continued to do so as a partner.

(b) The trustees had withdrawn their share of the partnership income and had deposited same in their own accounts during the years under review.

(c) The husband had been adequately compensated for his services by way of a substantial salary allowance before dividing income.

(d) The fact that the business was of a service nature and that capital was not a material income-producing factor did not alter the decision. Offsetting this factor was the fact that the bulk of the commission income earned by the business was produced by its employees and not by the taxpayer.

(*Milton Greenberger* v. *Commissioner*, CCA-7; November 7, 1949.)

Finally, no review of the family partnership status in 1949, however cursory, could overlook the fact that a District Court's decision in 1948, recognizing trusts for minor children as valid partners although created by gift, was upheld upon appeal and before the *Culbertson* decision.

(*Horace E. Thompson* v. *J. A. Riggs, Sr.*, CCA-8; May 20, 1949.)

Nor could we overlook the recognition by the Tax Court of a wife as a bona fide partner, although she had received stock as a gift from her husband on October 9, 1936, *after* he had decided to form a partnership. On October 31, 1936, the corporation was dissolved and a partnership formed. The wife contributed no capital other than the assets received by her on liquidation and rendered no services. The court ruled that the gift of stock was absolute with no strings attached and, hence, constituted original capital. Practitioners, however, should note the six dissents to this opinion.

(*Edward A. Theurkauf* v. *Commissioner*, 13 TC, No. 70; October 7, 1949.)

In general, practitioners would be wise to review their pending and settled partnership cases in the light of the *Culbertson* and subsequent decisions. If possible, settlements unless extremely favorable should be deferred until further developments. Protective claims

for refund in closed cases should definitely be considered.

Jacobson and Forgiveness of Indebtedness

In the aftermath of the *American Dental* case, taxpayers and the courts began to expand its doctrine (that a gratuitous cancellation of debt constituted a gift and hence was exempt from tax) into fields of accepted commercial activity. Thus, it was subsequently held that a purchase by a corporation or an individal of its or his own bonds at a discount, by tender and not in the open market, represented a "gift" by the creditor and hence was to be treated as non-taxable income.

This view was completely upset by the Supreme Court in its decision in the case of *Commissioner* v. *Lewis F. Jacobson* (69 S. Ct. 358, January 17, 1949). The majority of the Court held that there was a complete absence of donative intent in the transaction; that the creditor, in each instance, was not forgiving any portion of the debt, but was, in fact, attempting to secure the maximum out of it. Hence, there was no gift and no exempt income. The fiction of a distinction between "direct negotiation" and "open market" debt transactions was completely brushed aside. This view was adopted in the following subsequent decisions:

(a) Purchase by corporation of its own bonds at a discount:

(*Commissioner* v. *Pittsburgh & West Virginia Railway*, CCA-3; February 9, 1949. *The Smythe Building Company*, 12 TC 520; March 31, 1949. *New York Trap Rock Corporation*, TC Memo Decision; May 5, 1949.)

(b) Settlement of debt for portion thereof:

(*Astoria Marine Construction Co.*, 12 TC 798; May 20, 1949. *Pacific Magnesium, Inc.* v. *Westover*, U. S. District Court, Southern District of California; October 18, 1949.)

It would appear that the courts have gathered from the *Jacobson* decision that there must be a *complete* cancellation of the gift, an act of giving something for nothing, before a gift can be read into the transaction. Secondly, a positive donative intent running from creditor to debtor must be established. The act of taking a tax deduction on the part of the creditor for his economic loss in the transaction led the court, in one decision, to eliminate the existence of this necessary donative intent.

(*Pacific Magnesium, Inc., supra.*)

Other Supreme Court Decisions

Under the *Sansome* rule, it was clearly established that the profits of a transferor corporation in a tax-free liquidation or reorganization became a part of the accumulated earnings of the transferee. This was of vital importance in measuring the taxability of subsequent distributions by the transferee corporation.

The Supreme Court now holds that the same rule does not apply where the transferor corporation has a deficit; the accumulated surplus of the transferee is not reduced by the transferor's deficit. A possible means of overcoming Section 102 problems, or of converting distributions from ordinary income to returns of capital or capital gains, has thus been eliminated by this decision.

(*Commissioner* v. *Margaret R. Phipps*, 69 S. Ct. 616; March 14, 1949.)

A lump-sum payment to a non-resident alien author for the complete American rights to a book was subject to the withholding of income tax. The court ruled that:

(a) Although the payment was for the complete and exclusive American rights, it did not represent sales proceeds but royalty income; a copyright cannot be subdivided and conveyed piecemeal without being considered a licensing arrangement rather than a sale.

(b) A lump sum payment was not exempt from withholding because it was not "periodic" in nature.

(*Commissioner* v. *P. G. Wodehouse*, 69 S. Ct. 1120; June 13, 1949.)

Section 45

The Supreme Court, in a generally expected decision, upheld the Commissioner and ruled that the separate corporate entities of three wholly-owned subsidiaries of Air Reduction Corporation were to be recognized and taxed accordingly.

(*National Carbide Corporation, et al.* v. *Commissioner;* 69 S. Ct. 726; March 28, 1949.)

Although this decision was unfavorable to the taxpayers involved, it is the writer's opinion that it should prove of great value to taxpayers utilizing multi-corporate set-ups for tax reduction purposes. Furthermore, it should prove beneficial to those taxpayers who are dividing their business operations between a corporation and a partnership or individual proprietorship in order to secure maximum tax efficiency.

Where a partnership composed of stockholders of a corporation took over an operation previously performed by said corporation, the income therefrom could not be taxed back to the corporation where a valid business purpose for such separation could be established; where separate records were maintained; where intercompany charges were reasonable; etc.

(*Standard Fruit Product Company,* Tax Court Memo Decision; August 22, 1949.)

Where, on the other hand, a partnership was formed by a corporation's stockholders to purchase the corporation's net working capital at cost giving a note bearing 2% interest as consideration therefor; to rent its equipment for $3,000 per annum; and, thereafter, to conduct the same business under the same name, in the same manner and in the same premises; the income of that partnership was deemed taxable in full to the corporation. It was pointed out that this business was unitary in character and thus distinguishable from those cases where a partnership was formed to operate a severable branch of a corporation's business.

(*Twin Oaks Company,* Tax Court Memo Decision; March 23, 1949.)

Where individuals conveyed business assets to a corporation to avoid judgments thereon; operated said assets thereafter in the corporate name; and deposited proceeds in the corporate bank account; they could not thereafter report the bulk of the income as a partnership renting said assets from the corporation. The corporation could not merely be created to hold the assets, receive the income, pay all expenses without having it fully recognized as the true earner of the income for tax purposes.

(*W. G. Duncan* v. *Commissioner,* CCA-5; March 19, 1949.)

It is the writer's personal opinion that nothing has occurred in 1949 to prevent a taxpayer from breaking down his business operations on a multi-unit basis so as to secure maximum tax benefits, provided the operations are logically severable, separate records and bank accounts are maintained, and inter-company transactions are consummated for a fair or comparable consideration

Lease-Back Arrangements

The struggle of the Treasury Department to extend the rule of "substance over form" continued in 1949, and, with singular success . . . at least in the field of lease-back arrangements.

Where a corporation sold certain of its equipment to its sole stockholder subject to the condition that it be leased back at O.P.A.-fixed rentals, the court ruled the entire transaction without reality and disallowed the rent deduction to the corporation. Specifically the court stated "we find it to be nothing more than a mere assigning of corporate income . . ."

(*W. H. Armston Co., Inc.,* 12 TC 539; March 31, 1949.)

Corporation "A" conveyed all of its assets to its stockholders in liquidation. The same assets were then conveyed to a new corporation for all of its stock. In addition this second corporation agreed to pay the stockholders an overriding royalty of 5¢ a ton as additional

compensation for said assets. It was held that the "royalty" payment was neither "ordinary" nor "necessary" and hence was not deductible to the corporation.

(*Ingle Coal Corporation* v. *Commissioner*, CCA-7; May 11, 1949.)

Petitioners were engaged in business as a partnership. They purchased a parcel of land to be used in their business. This property was conveyed to a trust for their minor children and then leased back to them. The payments of so-called "royalties" and "rents" paid to the trusts were deemed gifts of partnership income and hence not deductible expenses of the business. It should be noted that there were six dissents to this decision, and rightly so, in view of the conflict between this case and the previously issued *Skemp* decision (CCA-7; 1948).

(*Helen and Earl M. Brown*, 12 TC 1095; June 21, 1949.)

Until and unless further decisions resolve this issue, taxpayers would apparently do well to avoid this device.

Sale of Corporate Property by Stockholders

The Commissioner continues, with an outstanding lack of success, to attack efforts of taxpayers to avoid the duplication of tax where a sale of corporate property is consummated. Generally the Commissioner has been confronted with either of these two transactions:

(a) Liquidation of corporation followed by sale of assets by stockholders.

(b) Sale of stock followed by liquidation by new stockholders in order to obtain higher cost basis of property.

A review of the 1949 decisions on this issue reveals the following:

Purchase of corporate stock as sole means of acquiring corporate assets followed by immediate liquidation in order to secure higher cost basis held not a sale of its property by the corporation.

(*Dallas Downtown Development Co.*, 12 TC 114; January 13, 1949.)

A sale of corporate property at the time of liquidation was held consummated by stockholders and hence the gain thereon was not taxable to the corporation. This decision was based upon the following facts:

1) Stockholders initiated negotiations to sell stock.
2) Prospective purchasers could arrange financing only for the purchase of the assets and not for the stock.
3) To overcome this obstacle, the corporation was dissolved on September 27, 1940, and the sale of the property was consummated by the stockholders in their invidual capacities on October 24, 1940.
4) Negotiations at all times were carried on by the stockholders and not by the corporation.

(*Cumberland Public Service Company* v. *U. S.*, U. S. Court of Claims; May 2, 1949.)

Similarly, the corporation avoided tax on the subsequent sale of its property by its stockholders, even though only nine days elapsed between the liquidation and the sale, and the sole purpose of said liquidation was to avoid the double tax. The important factor was the fact that, at no time, did the corporation negotiate for the sale in question.

(*Burke* v. *Smyth*, U. S. District Court, California; July 29, 1949.)

Where the corporation had, at no time prior to its dissolution, entered into any contractural obligation for the sale of its assets, it could not be taxed with the gain on the sale subsequently consummated by its stockholder. Conversations conducted prior to liquidation were deemed by the courts to be exploratory in nature; did not involve negotiations as to price, terms or quantity; and hence did not affect the findings.

(*H. Dixon Smith, Inc.*, Tax Court Memo Decision; August 31, 1949.)

The only adverse decision on this topic was the Circuit Court's affirmance of the Tax Court's *Kaufmann* decision. In this case, the sale of the property was negotiated by a corporate officer who was not a stockholder. After all terms had been set and the agreement reached, the corporation was dissolved, the property distributed in liquidation to its stockholders and then sold by the latter on the following day. On these facts no other decision could have reasonably been expected.

(*Rose Kaufmann et al.* v. *Commissioner;* C.C.A.-3; April 26, 1949.)

It may be of interest to note that the Tax Court's decision in the *Transport Trading & Terminal Corporation* case was reversed upon appeal (C.C.A.-2; July 11, 1949.) Here, property was distributed as a dividend by a subsidiary to its parent corporation at a time when the eventual sale of that property was assured. The court ruled that substance not form must be considered; that the sale subsequently executed by the parent corporation was, in fact, attributable to the subsidiary; and that the dividend distribution was purely a tax device. Practitioners who have used this procedure to substitute the lower dividend tax for the tax on the sale can expect serious difficulties unless the courts are given the opportunity to review similar cases and liberalize their approach as they already have in the more standard *Court Holding* situations.

Corporate Loans or Stock?

The courts are still wrestling with that almost eternal tax question . . . is it a stock investment or does it represent a loan to the corporation? How did the taxpayer fare on this question in 1949?

In a case replete with a set of truly disadvantageous facts a Circuit Court nevertheless reversed the Tax Court and found for the taxpayer. Practitioners would do well to study those facts and have them available when a revenue agent raises the same question:

(a) The original investment of cash was arbitrarily subdivided between stock and loans.

(b) Notes bore interest at rate of 6% payable quarterly. No interest was paid however for about 2 years. One payment of principal was made before interest payments were initiated.

(c) The books did not reflect the foregoing subdivision for about a year because the accountant was not apprised of this fact. The first tax return and financial statement of the corporation reflected the entire contribution as capital.

(d) One of the stockholders testified that he expected repayment only if funds were available; another expected interest payments only out of earnings.

(e) No dividends were paid although a surplus was available.

The court disregarded all of the foregoing and ruled that it was the intent of the parties at inception that a portion of the investment be deemed a loan and this intent must prevail.

(*Wilshire & Western Sandwiches, Inc.* v. *Commissioner,* CCA-9; June 23, 1949.)

Where advances to a corporation are evidenced by indicia of indebtedness, the courts will scrutinize them closely to determine their essential nature. Here taxpayers have met with failure where they have drafted instruments ostensibly representing loans yet giving the holders thereof a status essentially equivalent to that of stockholders.

(*E. P. Burton Lumber Company* v. *Bowers,* CCA-4; February 4, 1949. *The Jordan Company* v. *Allen,* U. S. District Court, Middle District of Georgia; August 4, 1949.)

Capital Gains and Losses

The year 1949 saw its full complement of cases involving the eternal struggle between the Treasury Department and the taxpayer as to whether or

not the gain or loss on any transaction was taxable under Section 117 of the Code. This problem was tried and tested from a variety of approaches:

Taxpayer succeeded in distinguishing between houses built primarily for rental and income-producing purposes and houses which sold without being occupied and within brief periods after completion. If held for more than 6 months, gains on former were capital gains under Section 117(j) IRC; gains on sales of latter houses were ordinary income because they were "intended and produced primarily for sale."

(*Elgin Building Corporation et al.*, Tax Court Memo Decision; February 15, 1949.)

Where taxpayer, a dealer in securities, transferred certain of its securities out of its inventory to an investment account, it was held that said securities were thereafter held for speculative and investment purposes and not primarily for sale. Gains on their subsequent sale were capital gains. Furthermore, permission of the Commissioner was not required for said transfer.

(*Carl Marks & Co., Inc.*, 12 TC 1196; June 30, 1949.)

Where a dealer in securities purchased stocks for investment purposes and kept them intact and apart from his so-called free securities which were traded in from day to day, gains on the sale thereof were capital gains.

(*E. Everett Van Tuyl*, 12 TC 900; May 31, 1949.)

Similarly an established real estate dealer was permitted to report gains on certain sales of property as capital gains where he could establish that these properties were purchased for investment purposes and that rentals had been collected thereon.

(*Nelson A. Farry*, 13 TC, No. 3; July 6, 1949. *R. H. Hutchinson*, Tax Court Memo Decision; June 22, 1949.)

An interesting conclusion emerges from the findings of the court in the case of *Stanley Switlik, et al.* v. *Commissioner*, (13 TC, No. 15; July 20, 1949). A corporation was completely liquidated in 1941, resulting in a long term capital gain to each of its stockholders. Several years later the stockholders as transferees, were obliged to pay corporate tax deficiencies. The Court ruled that these amounts were deductible as ordinary losses and not as capital losses, nor did they represent an adjustment of the original gains.

Does this decision conflict in theory with the findings of the court in the case of *Harry C. Westover* v. *Agnes F. Smith* (CCA-9; February 21, 1949)? Here the taxpayer received, upon dissolution of a corporation, a contract under which another corporation was to make future royalty payments. A fair market value could not be attribtued to said contract. It was held that royalty payments received in subsequent years constituted additional liquidation proceeds and were reportable as long-term capital gains. A similar conclusion had previously been reported by another Circuit Court in the case of the *Commissioner* v. *Susan J. Carter* (CCA-2; November 29, 1948).

A sale of patents by an individual to a corporation resulted in a capital gain because:

(a) Patents were not held for sale to customers in ordinary course of the business of being an inventor.

(b) Amounts received constituted proceeds of sales of patents despite the fact that they were computed on basis of a percentage of the sales price of the product made thereunder.

(c) Contract of sale was separate and apart from contract of employment, hence proceeds did not constitute additional wages.

(*Southwick N. Briggs* v. *Hoffenbert*, U. S. District Court, Maryland, August 5, 1949.)

Sale of Treasury Stock

Unless a conflict in Circuit Court decisions arises in the future with a resultant appeal to the Supreme Court, it would appear fairly certain that almost any sale of treasury stock will result in taxable income if vigorously contested

by the Treasury Department. The extremes to which the Department has gone in its offensive against treasury stock sales can be gathered from the two most recent decisions on the matter. In both cases the transactions were considered taxable despite the fact that:

(a) All sales were to employees for purposes of creating added interest in the business.

(b) Some of the stock was acquired by donations to the corporation.

(c) Absence of profit motive was virtually admitted by the courts.

(*Commissioner* v. *Batten, Barton, Durstine & Osborn, Inc.*, CCA-2; December 23, 1948. *Commissioner* v. *Rollins, Burdick Hunter Company*, CCA-7; May 19, 1949.)

Penalties

The tax law imposes penalties upon taxpayers who wilfully or negligently fail to comply with its regulations. During 1949, the courts were actively engaged interpreting the application of the penalty sections of the Code.

Where a decedent's income tax returns were found to be fraudulently filed, his estate was held liable for the fraud penalties.

(*Estate of M. T. Manton*, Tax Court Memo Decision; November 22, 1948. *Estate of L. L. Briden*, 11 TC 1095; December 31, 1948. *Estate of C. L. Reimer*, 12 TC 913; May 31, 1949.)

Where a wife joined her husband in signing returns prepared by him, which were subsequently found to be fraudulent, she was held jointly and severally liable for the fraud penalties imposed thereon despite the fact that she was not personally involved in the fraud.

(*Myrna S. Howell* v. *Commissioner*, C.C.A.-6; June 15, 1949.)

The filing of an amended return will not preclude the imposition of fraud penalties where the original return was fraudulently filed. Furthermore the basis of the 50% penalty is the difference between the recomputed tax and the amount shown on the original return.

(*Aaron Hirschman et al.*, 12 TC 1223; June 30, 1949. *Harry Sherin et al.*, 13 TC No. 31; August 19, 1949.)

If penalties for failure to file excess profits tax or personal holding company returns have been imposed in years that are still open, or where such penalties are now being proposed, it would be profitable for the practitioners involved to study the following 1949 decisions:

Where the income of an affiliated partnership was taxed to a corporation thereby creating an excess profits tax liability, the penalty for failure to file was considered inapplicable. Officers believed the partnership recognizable for tax purposes and hence failure to file was deemed attributable to reasonable cause.

(*Twin Oaks Company*, Tax Court Memo Decision; March 23, 1949.)

Where the disallowance of officers' salaries as unreasonable increased the corporate net income to a point where it became subject to excess profits tax, the negligence penalty for failure to file a return was considered in order. "The determination that the taxpayer should have filed an excess profits tax return followed the conclusion of the reasonable salary issue as a matter of course."

(*Al Haft Sport Enterprises, Inc.*, Tax Court Memo Decision; August 22, 1949.)

On the other hand, where the income of a corporation as computed by its president, who was an accountant, was less than the exemption, failure to file an excess profits tax return was deemed due to reasonable cause, despite the fact that the income was subsequently increased upon examination by capitalized repairs.

(*The Standard Fruit Product Company*, Tax Court Memo Decision; August 22, 1949.)

Taxpayer was informed by a reputable tax accountant and expert that it was not subject to the personal holding company surtax because its rent income was from a partnership and not from an individual stockholder. The courts held that failure to file was not willful.

(*Walnut Street Company* v. *Glenn*, U. S. District Court, Western District of Kentucky; March, 1949.)

On the other hand where the agent

of the corporation was not an expert and/or was not apprised of all of the facts, the penalty for failure to file was in order.

(*The 1040 Springfield Avenue Corporation*, Tax Court Memo Decision; March 11, 1949. *Haywood Lumber and Mining Company*, 12 TC 735; May 11, 1949. *Hermax Co., Inc.* v. *Commissioner*, CCA-3; July 29, 1949.)

Petitioner corporation was originally organized prior to the imposition of the personal holding company surtax and for a valid business purpose. The courts held that "there was a question debatable in good faith concerning the application to it of the statutory exceptions." The penalty for failure to file was deemed inapplicable.

(*Palm Beach Trust Company* v. *Commissioner*, CCA—District of Columbia Circuit; April 18, 1949.)

Personal Holding Companies

Personal holding companies may take, as a credit, the federal normal and surtax in arriving at its Subchapter A Net Income. Where the taxpayer is on the cash basis, the question has arisen as to which tax is deducted, the prior year's tax paid during the current year, or the tax on the current year's income. This question has not been finally determined. The Tax Court continues to hold that it is the tax actually paid during the year, despite other court decisions to the contrary.

(*Joan Carol Corp.*, 13 TC, No. 11; July 15, 1949. *Aramo-Stiftung* v. *Commissioner*, CCA-2; March 10, 1949. *Reliance Feed & Grain Co., Inc.* v. *Shaughnessy*, U. S. District Court, New York; February 4, 1949.)

Miscellaneous Decisions

Current state income taxes actually paid in the current year may be deducted by a cash basis taxpayer provided the state will accept such prepayments. A taxpayer with an unusually high income in any given year should consider this simple form of tax savings.

(*W. B. Glassell*, 12 TC 232; February 24, 1949.)

It would appear that an accrual basis taxpayer may deduct interest even though its ultimate payment seems "extremely doubtful." Unless evidence was submitted by the Commissioner indicating that payment definitely would not or could not be made, mere uncertainty of payment would not be sufficient to cause its disallowance. A note of caution is required in weighing the effects of this case. The Tax Court was apparently influenced in its decision by the fact that, if appealed, this case would have gone to the 8th Circuit, which had already ruled in favor of the taxpayer on this issue in the *Zimmerman Steel Co.* case (130 F. 2d 1011).

(*D. J. Jorden*, 11 TC 914; November 30, 1948.)

The rationale of the *Cohan* decision, which recognized the right of the taxpayer to the allowance of a reasonable estimate of deductible expense notwithstanding the absence of direct substantiation thereof, has been extended by the courts into other fields. In one late 1948 decision, the taxpayer claimed that its records covering the cost of reconditioning a mine had been lost or stolen. Estimates of such costs by the petitioner's principal officer were submitted orally at the trial and accepted by the Court as a basis for allowing 80% thereof as the cost of the asset for purposes of computing loss. The writer is presently engaged in attempting to extend the *Cohan* doctrine into a War Loss case.

(*Tressler Coal Mining Co.*, Tax Court Memo Decision; December 8, 1948.)

Another late 1948 decision worthy of note involved the pro-rata partial liquidation of the outstanding common stock of a corporation. The Commissioner attempted to tax the entire amount distributed as dividend income to each stockholder under Section 115(g) of the Code. The Tax Court rejected this view pointing out that it had been clearly established that the corporation required less capital because of reduced operations. This situation arose from a fire which had destroyed a portion of the corporation's facilities. Replacement

of these facilities was not considered feasible.

(*Joseph W. Imler*, 11 TC 836; November 22, 1948.)

Salary or other income properly received in one year continues generally to be taxed in that year even though the taxpayer may become compelled to return it in a subsequent taxable period.

(*John O. Maxwell*, Tax Court Memo Decision; February 3, 1949. *C. Henry Haberkorn, III* v. *United States*, CCA-6; March 28, 1949.)

Where an accrual basis taxpayer failed to include, in prior years' income tax returns, accounts receivable of those years, the Treasury Department may not include those sales in the current year. This case is being appealed by the Commissioner.

(*Estate of Samuel Mnookin*, 12 TC 744; May 12, 1949.)

On the other hand where income was improperly accrued and reported in prior years, failure to receive such amounts does not give rise to a deduction in the current year.

(*P. I. Redcay*, 12 TC 806; May 20, 1949.)

Where a portion of the expenses of an officer-stockholder, which were reimbursed by the corporation, was determined to constitute personal expenses, that portion of the reimbursement was taxed to the individual as dividend income. This decision could have disastrous repercussions among a great many taxpayers, if strictly administered by the Department.

(*Victor Cooper*, Tax Court Memo Decision; August 8, 1949.)

A Florida rest cure was not allowed as part of a medical expense deduction. Taxpayer failed to prove that this trip bore a direct relationship to the cure, mitigation or treatment of a particular ailment.

(*Martin W. and Mabel M. Keller*, Tax Court Memo Decision; August 1, 1949.)

Attorneys' fees in connection with contesting a gift tax deficiency were held deductible as directly connected with the maintenance of income-producing capital. (Section 23(a)(2) I.R.C.). It will undoubtedly require more litigation before this obviously equitable rule will be accepted by the Commissioner.

(*Joseph T. Lykes* v. *U. S.*, U. S. District Court, Florida; June 3, 1949.)

The "retirement" of a corporate security gives rise to a capital gain or loss under Section 117(f) I.R.C. The Commissioner has always interpreted this to require complete retirement of each bond or note. The courts have rejected this view and hold that each payment of a piecemeal retirement of corporate securities falls within the purview of Section 117(f).

(*H. C. Avery*, 13 TC, No. 49; September 23, 1949.)

Of possible continuing comfort to the practitioner is the knowledge that any adjustment to the taxpayer's closing inventory by the Treasury Department must be accompanied by a similar adjustment to the opening inventory.

(*E. J. Scheer, Inc.*, Tax Court Memo Decision; October 7, 1949.)

The balance of unamortized leasehold expenses and leasing commissions was held not deductible where taxpayer was liquidated at close of taxable year. Whether the stockholders could continue to amortize these expenses and whether they constituted an asset upon liqudation was not made clear.

(*Margaret Wolan et al.*, Tax Court Memo Decision; October 12, 1949.)

A late 1948 Circuit Court decision, now pending before the Supreme Court, may affect a considerable number of taxpayers. This case ruled that the application of the carry-back provisions of the Code abolished the right of the Department to collect interest on an assessed or "potential" deficiency which is subsequently eliminated by the carry-back of a future year's loss. Claims for refund in all affected cases should be filed pending the Supreme Court's decision.

(*Seeley Tube & Box Company* v. *Manning*, CCA-3; December 20, 1948.)

Tax Problems in Real Estate Operations

By Louis Winsten, C.P.A.

During the past few years there have been a considerable number of decisions on real estate problems. Some have involved questions never decided before and other decisions have applied well-settled tax principles to borderline situations. As a result, the tax consequences of some real estate transactions have been clarified and, in other situations, it is apparent that the facts, rather than a tax principle, will control the result. A review and analysis of these decisions should prove helpful in advising clients on the tax effects of real estate operations and anticipating the Internal Revenue Bureau's attitude on unsettled issues.

Repairs and Capital Improvements

The distinction between expenditures which are repairs and those that are capital improvements, has long bothered accountants and tax practitioners. Items which are clearly repairs and those which are undoubtedly capital expenditures, do not create a problem. It is the expenditures which are borderline that continue to require clarification. The classification has been made on the basis of the purpose of the expenditure. To repair is to restore to a sound state or to mend, whereas a replacement indicates a substitution or improvement. The courts have considered that a repair does not add to the value of property nor does it prolong its life to any considerable extent, but merely keeps the property in an operating condition over its probable useful life for the uses for which it was acquired.[1]

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But when these principles are applied to specific cases where expenditures could possibly satisfy the test both as a repair and as an improvement, we realize that these principles cannot be easily applied. The area of uncertainty involves what type of expenditures extend the useful life expectancy. This doubtful area was clearly indicated in *American Bemberg Corp.*,[2] which involved a corporation manufacturing rayon yarn, that erected its factory on land which was found to be subject to subsurface disturbances. A series of cave-ins occurred which caused several spinning machines to be lost or damaged. On advice of engineers, the corporation, faced with the possibility of abandoning the plant, spent large sums in stabilizing the foundations. The Tax Court concluded that this work of drilling and filling-in was not a work of construction nor the creation of anything new. The work was limited to filling cavities in the soil caused by fluid discharges from the plant during its operation and not to filling old cavities in the bedrock. As a result of these findings, the cost of such work was allowed as a fully deductible business expense.

It is understandable why the Commissioner is appealing this allowance not only because it amounts to a deduction of over $1,000,000, but also because in principle the expenditure was to protect a capital investment. How-

[1] *Illinois Merchants Trust Co., Exr.* 4 BTA 103; *Union Pacific RR. Co.* v. *U. S.*, 99 U.S. 402; *Universal Mills*, Memo TC, Dkt. No. 16663, 11-26-48.

[2] 10 TC 361, NA 1948-2 CB-5, aff. (CCA-6; 10-17-49).

ever, work of a substantial cost has been classified as repairs if the property was not placed in a better condition or given a longer life expectancy than when originally constructed. Reg. 111, Sec. 29.23(a)-4 specifically permits a deduction for "the cost of incidental repairs which neither materially add to the value of the property nor appreciably prolong its life". In *Edward G. Buckland* v. *U. S.*, 66 F. Supp. 681 (1946), the taxpayer spent 35% of the value of the building in order to repair leaky walls and roof within 16 months of the purchase of the property. Such expenditures were deductible as repairs.

The fine distinction that is being made in repair versus capital improvement cases was demonstrated again in *Difco Laboratories, Inc.*[3] The corporation manufactured chemicals in adjoining buildings whose basement floors were not on the same level. Due to large Government orders in 1942, the corporation decided that it would be more efficient to bring the floors to the same level so that material could be more easily handled. The elevator shaft was extended to the basement level. These expenditures were treated as ordinary business expenses by the corporation, but the Tax Court held that they should be treated as additions to capital. The emphasis was not whether the expenditure was to keep property in an efficient condition or to effect a replacement or improvement, but whether the outlay resulted in adapting the property to a *different use*. Since the basement floor was put to a different use after the alterations, the cost was treated as a capital investment. This test, emphasized in the *Difco* decision, may prove helpful in borderline cases.

Perhaps the difficulty of classification was best demonstrated in another decision with extremely simple facts, *Robert M. Craig.*[4] A farmer rented a building to one of his workers to be used as a residence. The roof became leaky and to prevent his worker from leaving, the farmer ordered several bundles of shingles to fill the holes. Upon discovering numerous other leaks, he decided to cover the old shingles with new composition shingles to cover the entire roof. This work did not change the structural features of the house nor were any of the old shingles removed.

The Tax Court decided that the cost of the shingles was a capital improvement, not a repair. Had the farmer merely covered the holes in the old roof, the cost would have been deductible. By replacing the entire roof, the work became an improvement not a repair. It is interesting to note that the Court thought the farmer's change of intention, from covering the holes in the roof to covering the entire roof, as a good illustration of the difference between a deductible repair and a non-deductible improvement. Apart from the value of this simple set of facts to point out the distinction and clarify our thinking, the *Craig* decision indicates that the Court will consider the taxpayer's intent as well as the character of the expenditure to determine how it should be treated.

In certain cases it may be possible for a taxpayer to seek a deduction for repairs and in the alternative as a casualty loss. When the damage creating a need for repair is caused by a casualty such as a fire, flood or storm, the restoration costs may conceivably be claimed as a deduction under Sec. 23(a)(1), business expense, or Sec. 23(e)(f), casualty loss. The value of an alternative pleading was demonstrated in *Harris Hardwood, Inc.*, 8 TC 871, in which the cost of replacing washed out roads and trackage as well as building a new levee to prevent damage from future floods was deducted. The Tax Court disallowed the deduction as a business expense, but allowed both the cost of replacing washed out roads as well as the cost of a new levee as a casualty loss.

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3 10 TC 660; acquiesced 1948-2 CB 1.
4 Docket No. 13843, 7 TCM 532.

Although the cost of a new levee would appear to be a capital improvement as the Commissioner argued, it was de-deductible as a casualty loss.

A loss deduction is also permitted for the cost basis of a demolished building plus the cost of such demolition provided this action was not contemplated when the building was acquired. Recently the Tax Court approved a deduction of the cost of a demolished building, less salvage and depreciation to the date demolition started.[5] The Commissioner had contended that the taxpayer intended to demolish the building for a parking lot when he purchased it so that any cost of demolition would be capitalized.[6] Facts, however, established that the owner changed his plans and decided to raze the building after purchase so that the cost of the building was deductible as a loss. Deduction of such a loss is dependent upon the intention of the taxpayer at the time the property was acquired. In the event demolition was contemplated when the property was purchased no deduction for loss in value will be allowed.

Accrual of Realty Taxes

Another question of considerable interest, is the deduction of realty taxes. Particularly as to the time title is transferred, the rules regarding deduction of realty taxes remain uncertain. Who may deduct such taxes and when do they accrue?

The Supreme Court has approved the statement in the Regulations (Sec. 29.23 (c)-1) that "taxes are deductible only by the person on whom they are imposed." This was applied in *Magruder* v. *Supplee*,[7] to deny the purchaser of real estate in Maryland a deduction of an amount paid for realty taxes which were a lien prior to transfer of ownership. The Court set forth the rule that the person who is personally liable or who owns the property at the time the tax has become a lien, is entitled to deduct the full amount due. Therefore, a buyer cannot deduct any part of the tax if he acquires title after the date the lien attaches, unless he is personally liable to the taxing authorities for the amount.

While the *Supplee* decision established the rule that there can be no allocation of a realty tax deduction between buyer and seller, confusion still exists as to the proper date that realty taxes accrue. This question would not arise if a personal obligation to pay the realty tax had arisen. When a personal obligation does not exist, then the question of the accrual date is important.

In New York City, the Bureau had ruled that the real estate tax accrues for a full year at the time when under the New York City Charter the real property assessment rolls are delivered with warrants attached, authorizing collection of the taxes.[8] Under the Charter, the assessment rolls are to be delivered on or before June 30th. However, court recognition of the lien dates on New York City realty tax as the date of accrual, i.e., October 1st and April 1st was obtained in the case of *Robert LeRoy*.[9] This decision used the lien date according to the test in the *Supplee* decision, but did not decide the question of personal liability.

Not until 1947, did the Tax Court pass upon the question of personal liability for New York City realty taxes. Although Sec. 71 of the general tax law of New York State creates a personal liability, it was unsettled whether New York City real estate taxes, imposed under the city charter which contains no provision for personal liability, created such a liability on the real estate owner. The question was finally faced in *Adda, Inc.*[10] In that case, the

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5 *Work Clothing Corporation*, Docket No. 13062, CCH Dec. 17004 (M).
6 Reg. 111, Sec. 23 (e)-2.
7 316 U.S. 394 (1942).
8 I.T. 3527, CB 1942-1, P.53.
9 4 TC 70, aff. (CCA-2; 1945) 152 F. (2d) 936, acquiesced IRB 1949-11.
10 9 TC 199 affirmed 171 F (2d) 367.

taxpayer purchased a building on August 5, 1940, and received a real estate tax bill for the year July 1, 1940, to June 30, 1941, which it paid in full. The Commissioner sought to deny a deduction because he claimed that the accrual date was the assessment date which was before the transfer of ownership. In addition, it was claimed that the taxpayer was a resident of the taxable district in which the property was located, having its sole office and place of business there, and so was personally liable for the tax. The Court refused to accept either argument, not only holding that no tax lien arose until after the sale, but also that there is no personal liability for New York City real estate tax. Accordingly the tax was deductible in full by the purchaser who owned the property when the tax became due and payable on October 1 and April 1.

As a result of the *LeRoy* and *Adda* decisions, I.T. 3527 was revoked (I.T. 3964, IRB 1949-17) and by G.C.M. 26069 the Bureau has ruled that New York City realty taxes accrue as of October 1st and April 1st of each year, the lien dates, when one-half of the annual tax is due. However, a question arises with respect to those taxpayers who have heretofore carried out the provisions of I.T. 3527 in closing its books for a number of years by accruing realty taxes to the following June 30th. It appears that such taxpayers, in changing to G.C.M. 26069, should close out to surplus that portion of the accrual made at the end of its previous year which is excessive under the provisions of G.C.M. 26069. The deduction then taken in the current taxable year for realty taxes would then follow the new ruling. Will the Treasury Department tax as income in the year of change the surplus adjustment made as suggested? It is the writer's opinion that since the error was that of the Commissioner in his previous interpretation (I.T. 3527), the taxpayer is entitled to a full twelve months' deduction of real estate taxes in the year under review, and the Commissioner cannot add to the income of such year any adjustment of an erroneous realty tax deduction made in the prior year. Decisions have barred the Commissioner from including in income in one year an amount which was erroneously allowed as a deduction in a previous year.[11]

On the question of personal liability for realty taxes, a recent decision involving Detroit, Michigan, taxes should clarify the situation. A purchaser had acquired an executory contract of purchase before the assessment date, and acquired title and possession after the assessment date but before the lien date. He paid the taxes after the lien date. The Tax Court in *Gilken Corp.*[12] denied a deduction by the purchaser, even though he held title before the lien date. The Court devoted itself to the question of whether the purchaser, who held only an executory contract to purchase on the assessment date, could be treated as personally liable for the tax on that date. Since it was concluded that personal liability only applies to the legal owner, the purchaser who held at the most only an equitable interest on the assessment date was denied a deduction.

This case is of particular interest because the Courts appear to consider that the assessment date rather than the lien date is critical. This may be distinguished from the decisions on New York City realty taxes because of the terms of the charter provisions of Detroit. Under its charter, the city taxes become a debt against the owner when the assessments are posted, although the tax does not become due until the lien date. The Court in following the Supreme Court's rule in the *Magruder* v. *Supplee* decision sought to determine who was personally liable on the assess-

[11] *Green Motor Co.,* 7 TC 314; *Estate of Samuel Mnookin,* Dec'd, 12 TC 99, non-acq. IRB 1949-23.

[12] 12 TC 445, affirmed 176 F. (2d) 141.

ment date—the date the debt arose—since local law indicated that the accrual should be made as of the assessment date.

The different conclusions in the *Adda* and *Gilkin* cases, due to a variance in the provisions of the New York City and Detroit charters, point to the need for more uniform laws throughout the country. It is true that the Commissioner limits the scope of each court decision to a particular locality but the confusion which arises in trying to use decisions as a precedent indicates the need for a clarification of the situation. At present, some localities use the assessment date, and other localities indicate that the lien date shall be the date upon which the real estate owner must accrue taxes due. Perhaps the American Institute of Accountants may be effective in such a movement to standardize local laws.

Purchase of Property By Lessee

Another problem that may confront a purchaser of real estate is his treatment of the purchase price in the case of the purchase of the fee by a lessee of the property. A principle, offering considerable tax saving possibilities, was expounded in the Circuit Court decision for the 6th District, *Cleveland Allerton Hotel, Inc.*[13] The Court approved as an ordinary deduction a portion of the amount paid for purchase of title to property. The purchaser owned and operated a hotel building on land leased for 99 years at $25,000 a year, a rental considered excessive by $15,000 a year. It purchased the fee in the land which was valued at $200,000 for $440,000. The Circuit Court ruled that the portion of the consideration paid for the deed above $200,000 should be treated as an expense paid to escape the rental obligations under the lease. Allowance of approximately $240,000 as an ordinary deduction represented damages paid to secure relief from an unprofitable lease.

The Government has indicated that it will not apply for certiorari in this case. Hence, the case stands for the proposition that a tenant, who is paying excessive rental and decides to buy the property, may treat the portion of the purchase price in excess of fair market value as a payment of damages to avoid an unfavorable lease. The Tax Court had sought to distinguish between the value of the lease and the value of the land so as to allow depreciation of a portion of the amount. However, being unable to allocate the amount paid between lease and land, it refused to allow a deduction of any portion of the cost price. Now that the Tax Court has been overruled in a case not reviewed by the entire Court, it remains to be seen whether it will accept the view of the Circuit Court and whether the Commissioner will bring a similar suit in another Circuit to obtain affirmance of the Tax Court view that the full cost is to be charged to land.

This decision by the higher court could create a precedent for breaking down and analyzing a purchase price. If it can be established that the cost for property was excessive, a portion of the amount paid may be deductible. Generally, an unreasonably high price is paid when the purchaser finds himself in a poor bargaining position for one reason or another. Whether the purchaser is the tenant who seeks to escape a high rental or a neighbor who buys property to protect his own, this decision may support an allocation of cost between capital investment and damages paid. But, such a break-down even if possible, would be against recognized accounting procedure. No matter how the various items making up the cost have been classified, we have generally capitalized the amount. If a portion were allocated to cost of canceling the lease, the amount paid could have been written off over the term of the cancelled lease. If we must look behind

[13] 166 Fed. (2d) 805, reversing 6 TCM 498.

the cost to determine why the amount was paid so that some portion may be deducted at once, it may offer a substantial tax saving but it would upset a standard accounting principle.

Payments to Cancel a Lease

Related to this problem is the treatment of the cost to a landlord or tenant in order to cancel a lease. Generally the intent and surrounding circumstances are of considerable weight. In general, when a landlord pays an amount to his tenant for cancellation, it may be amortized over the unexpired term of the cancelled lease.[14]

However, there are exceptions due to factual situations[15] where the cost of cancellation was amortized over the term of the new lease. The landlord had a lease pending with the United States when he sought cancellation of the old lease, and the rent paid by the Government included consideration paid the old tenant so that the payment was amortized over the term of the new lease as part of its cost.

When a tenant pays his landlord a sum to escape the obligation of a continuing lease, it appears well settled that the amount is deductible as a business expense. Actually the court has considered the amount paid as damages to obtain relief from an unsatisfactory lease and *not* to be amortized over the period the cancelled lease would have run.[16] It is important to remember this distinction; that, in general, a landlord must amortize the amount paid over the term of the old lease, whereas a tenant who pays to avoid a lease may deduct in full the amount paid.

Construction of Building by Lessee

When a tenant constructs a building upon land that he has rented, he and not the landlord is entitled to depreciate the cost of the building.[17] This general rule is well settled with the period of depreciation measured by the life of the property or the term of the lease, whichever is shorter.[18] However if the period of tenancy is indefinite then the life of any improvement is the period over which the tenant may depreciate the cost.[19] Where the landlord contributed part of the cost of the building to the tenant, the tenant still may be entitled to depreciation on the full cost. This corollary has been approved where the contribution was not actually treated by the landlord as an investment in the building, but as an investment in the land and hence not depreciable. This situation arose in *Comm.* v. *Revere Land Co., Grant Bldg. Inc.* v. *Comm.*[20]

However, this decision of the Circuit Court, which is contrary to the views of the Tax Court, and contrary to good accounting practice, was undoubtedly influenced by the peculiar facts. The parties were related: the Revere Land Company, the landlord, owned 50% of the common stock of the Strasswill Corporation, the promoter, and the latter in turn owned 90% of the common stock of Grant Building Inc., the tenant. Revere contributed $1,026,277.50 towards the cost of a 35-story building erected by Grant at a cost of approximately $5,600,000. This was pursuant to a 99 year lease with 9 renewals of 99 years each at the lessee's option. The annual rental was fixed at 6% of the cost of the land to Revere, the landlord, plus its contribution to the building construction. Revere, the landlord, charged the sum advanced to the cost of the land and for 13 years did not deduct any depreciation on said cost. At the same time it knew that the tenant deducted depreciation annually on the entire cost of the

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14 *Laurence Walker Berger*, 7 TC 1339.

15 *Wells Fargo Bank and Union Trust Co., Trustees of Clara Hillman Heller* v. *Commissioner* (CCA-9; 1947) 163 F. (2d) 521, which reversed 7 TC 556.

16 *Gassatt* v. *Comm.* (CCA-3; 1943) 137 F. (2d) 745, affirming 47 BTA 400.

17 Reg. 111, Sec. 29.23 (a)-10.

18 *The Lamson Building Co.* v. *Comm.* (CCA-6; 1944). 141 F. (2d) 408.

19 *Abraham Olshine*, Memo TC, (Dkt. No. 9319, 5-20-49).

20 CCA-3, (1948) 169-F. (2d) 469 reversing 7 TC 1061; cert. den. 10-25-48.

property including the amount contributed by the landlord.

The Circuit Court emphasized the treatment on the books and tax returns as carrying out the intent of the parties, that the landlord has only an interest in land and that the tenant made the entire investment in the building. The Tax Court, had gone behind the books and upon the basis of the *Detroit Edison Co.* decision[21] held that the lessee was not entitled to depreciation on someone else's contribution, but that the landlord having made the contribution in connection with the lease, was entitled to such depreciation.

Although the Circuit Court recognized the intent and wishes of the parties, it is not often that the courts will disregard the substance vs. form doctrine. The denial of certiorari by the Supreme Court indicates that it has approved a distinction between a contribution toward the construction of depreciable property which may be amortized and a contribution which is not depreciable. Even if the landlord could not claim depreciation on a capital investment, it would appear proper to recognize the contribution as the cost of acquiring the lease and depreciable as such over the term of the lease. The *Revere* decision appears to make bad law and it is unlikely that the courts will give it much weight.

Depreciation Problems

In some instances no one may be entitled to depreciation deductions on the cost of a building. If the cost or part of the cost of a building represents a gift to the owner it would not appear to be depreciable. So in *C. L. Downey v. Comm.*,[22] $25,000 paid by a Chamber of Commerce to induce the location of new business in the city could not be included as part of the basis for depreciation of the taxpayer's building. The money was not an investment, but was a contribution for the public interest. It was not considered to be part of the cost to the taxpayer and the depreciation basis was reduced accordingly.

A recent decision was rendered by the Tax Court on the question of whether the basis for depreciation may be retroactively reduced by the purchase of tax liens at a discount.[23] The opinion, in the taxpayer's favor, was to the effect that the basis for purposes of depreciation, prior to the year of purchase of the liens, should include the full amount of the lien. Briefly, the taxpayer had purchased a theatre in 1941 with outstanding liens and penalties exceeding $120,000. The face amount of this obligation was included in the cost of the property in addition to cash amounts paid the seller. In 1946, after the theatre company had acquired new interests, the liens were purchased at a public sale for approximately $50,000. The Treasury Department thereafter reduced the taxpayer's cost basis retroactively to the date of acquisition in 1941, by allowing for depreciation purposes the cash paid plus only the actual cost of the liens. The Court agreed, with one dissent, that the taxpayer was entitled to depreciate on the full face amount of the liens from 1941 to 1945. Of course, the basis was adjusted in 1946 after purchase of the liens at a discount.

The argument on this issue was based principally upon the *Crane* decision,[24] which approved the principles that the basis of property includes liens even though not personally assumed by the taxpayer and that the depreciation allowance should be computed on the full amount of this basis. The *Blackstone* decision carries this principle into actual application and denies any retroactive adjustment of basis. Furthermore, it reaffirms the principle that depreciation is computed on the basis of the facts known as of a given year; a

[21] 319 U.S. 98 (1943).
[22] 172 F. (2d) 810, affirming 10 TC 837.
[23] *Blackstone Theatre Co.*, 12 TC 801, (acq. IRB. 1949-19).
[24] 331 US 1.

taxpayer cannot be expected to anticipate a purchase of an obligation at a discount any more than he can anticipate acceleration in the rate at which property depreciates.

On the question of depreciation, it may also be of interest to note that in the *Adda* decision, referred to above, with regard to realty taxes, the Tax Court recognized the useful economic life of the two-story Bond Store building in the Times Square area of New York City as shorter than the useful physical life of the building. The building had been constructed in 1935 as a "taxpayer" on land considerably higher in value than the building. The court recognized the likelihood that by 1956, the date the Bond lease would expire, the present building would be removed and a taller one erected that would produce revenue more in keeping with the value of the lot.

The decision is further precedent for the principle that depreciation may be accelerated if abnormal conditions can be shown.

Classification of Real Estate

The classification of real estate as personal or business investment is important to determine how it should be treated upon sale, as well as whether it is depreciable and its expense deductible. As in other tax problems, it is the borderline situation which causes difficulty. When the issue is the conversion of a residence to business use, the actual status at the date of sale may be questioned. When the issue is treatment of income-producing property sold by a business, the classification of property as used in the regular course of business or as an investment becomes important. In each situation the use of property determines its classification and will determine whether the gain or loss is fully taken into account or subject to the limitations of Sec. 117 and the benefits of Sec. 117 (j). Several recent decisions in this field indicate the factual situations which still plague the tax practioner.

The Tax Court has created a distinction between business and isolated property held for investment purposes. This distinction has become important to determine allowance of an operating loss carry-over. Although the loss upon sale of business or non-business income-producing property is deductible, not all such losses may be included in a net operating loss carry-over. In two recent cases, the Tax Court has denied the use of Sec. 122 dealing with the operating loss carry-over in the case of a loss not attributable to the operation of a trade or business regularly carried on. This is because of the limitation in subsection (d)(5) applicable to individuals. In *Joseph Sic,*[25] the sale by a farmer of part of his farm land was not part of his regular business and the loss realized could not be carried over. Such a sale of land was outside of the normal activities of farming. This same situation existed in *Hartwig N. Baruch,*[26] which followed this *Sic* case. The point of view was affirmed in *Lazier* v. *U. S.*[27] which is the first Circuit Court decision on this question. However, the Circuit Court did not appear too confident of its position and recommended a review by the Supreme Court of this issue. The Bureau and Courts have apparently limited Sec. 122 (d)(5) to a carry-over of a net operating loss to the extent that it arises from the operation of a business regularly carried on and not including the isolated sale of income-producing property *used* in the regular trade or business.

The importance of classification has also been demonstrated in several recent decisions involving the sale of real estate by individuals who were not dealers but who invested in properties as an income-producing venture. A very helpful decision is *Leslie R. Boom-*

[25] 10 TC 1096, decided June 10, 1948.
[26] 11 TC 96.
[27] CCA-8 (1948), 170 F (2d) 521, affirming 77 F. Supp. 241.

hower, v. *U. S.,*[28] because of its thorough review of previous decisions and its summary of tests used to analyze the nature of the transaction. In this case, a lawyer who acquired title to real estate in order to avoid a loss to a trust and not to realize any individual profit, was allowed to treat the gain upon sale as a capital gain. The lawyer continued his law practice, divided the real estate only in order to sell it and acquired no other real estate. Accordingly, the court concluded that the sale of real estate was not in his regular business. However, in several recent decisions the facts were such as to cause the taxpayer to be treated as a dealer in real estate with the gain included as ordinary income.[29]

An effort has been made by real estate operators to establish that not all property which they acquire must be treated as property primarily held for sale to customers in the ordinary course of trade or business. If sufficient evidence is available to prove that certain property was acquired for investment purposes, solely to produce income, then even a real estate dealer should be entitled to report gains from sale of such property under Sec. 117 (j) as a capital gain. The Tax Court has held "where the owner of depreciable property devotes it to rental purposes and exclusively to the production of taxable income, the property is used by him in a trade or business".[30] Accordingly, it does not consider real estate held by a real estate dealer for rental purposes as a capital asset. However under Sec. 117 (j) I.R.C., gain on sale of real estate held for more than six months and used in a trade or business is treated as a long term capital gain. This view was confirmed in *Nelson A. Farry et al.,*[31] in which a taxpayer in the insurance and real estate business who had sold certain properties, held for investment purposes, was recognized as having realized a long term capital gain under Sec. 117 (j). The fact that gain from sale of certain realty is ordinary income does not prevent other realty sales by the same dealer from being classified as long term capital gains, provided the records distinguish between properties held for resale and properties held for investment.[32]

Other fine distinctions were brought out in other recent decisions. In *Spanish Trail Land Co.,*[33] the sale of property by a corporation created to dispose of real estate, which its incorporators had acquired upon foreclosure, was treated as ordinary income, regardless of the sale being made to liquidate real estate holdings. Had the property been held by the individual stockholders and sold by them individually, it is likely that any gain would have been limited by Sec. 117.

A fully deductible loss applying the same principle was allowed in *C. E. Roseman,*[34] even though lots acquired by a part-time real estate owner and operator were not income-producing at the time of sale. The Court did not consider that a conversion from business to investment property had occurred merely because the real estate was unable to yield any income. This same principle, that property remains business in character even after it is no longer income-producing, was applied to an individual who devoted a small part of his time to real estate activities. When a hurricane destroyed one of his rented houses, the Commissioner disallowed the full deduction of his loss upon sale of the vacant land since it was not longer income-producing. The Tax Court however, in *Solomon*

[28] 74 F. Supp. 997.

[29] *Eddy D. Field,* TC Memo (Dkt. No. 13722; 2-23-49); *George J. Wibbelsman,* 12 TC 1022.

[30] *John D. Fackler,* 45 BTA 708; affirmed (CCA-7;1943), 133 F (2d) 509.

[31] 13 TC No. 3.

[32] *R. H. Hutchinson et al.,* Memo TC (Dkt. Nos. 20118-9; 6-22-49).

[33] 10 TC, 430, decided March 16, 1948.

[34] TC Memo, 7 TCM 185, (4-7-48).

Wright, Jr.,[35] approved the deduction as an ordinary loss.

But the Tax Court did make a distinction in the case of sales of real estate by a taxpayer almost ten years after the dissolution of a real estate firm in which he held an interest. Such sales by him were as an individual who had abandoned the real estate business in favor of law and other employment. In this case, *James L. Vaughan*,[36] the loss was treated as a capital loss but no mention was made in the decision of the possibility of allowing a full deduction under Sec. 23 (e)(2) of a loss upon a transaction entered into for profit. It is generally advisable when claiming such a loss to seek relief under that provision in the event the transaction cannot be recognized as a business loss.

The recognition of intent as an important factor in classifying real estate transactions appears in the Tax Court's decision of *Carter Colton Cigar Co.*[37] The taxpayer bought unimproved land with the intention of erecting a business building but the plan was abandoned. Loss upon sale of the real estate was considered a business loss because the property had been devoted to and used in the business but this appears to be stretching the facts to fit the provisions of the statute. The loss could have been allowed under Sec. 23 (e)(2) as a transaction entered into for profit. Regardless of which Section is applied, it appears that the courts are considering the taxpayer's intent as well as the use of the property. To provide evidence of that intent, it is always advisable to provide corporate minutes or other business records of the purposes for a real estate purchase.

However, a limitation upon the influence of a taxpayer's intent was demonstrated in the case of residential property which was abandoned as a residence and advertised for sale or rent. The taxpayer was unable to rent it and sold it at a loss four years later. The Circuit Court in *Rea E. Warner* v. *Comm.*,[38] denied the loss because it was still residential in character even though the owner intended it to become income-producing. The allowance of depreciation on the property after it was abandoned as a residence apparently does not affect its classification upon sale.

Rent to Stockholders

In reviewing current problems in real estate operations, there are certain tax questions which are broader in scope but apply to certain realty situations. So the question may arise—how much rent may be paid a stockholder renting property to a corporation without the amount being declared excessive? The possibility that part of the rent may be treated as a distribution of profits and disallowed as a deduction should be an ever-present consideration. Such a result was reached in *Limericks, Inc.*,[39] where a portion of the rent was disallowed as an expense. The Commissioner and the courts compare the rent paid with expert opinion of reasonable rental for similar property in the same district. This conclusion was also reached in *Iron City Industrial Cleaning Corp.*[40]

Such a disallowance of rent as a deduction by a corporation also raises the question whether the stockholder must report it as income. In the *D. H. Willey Lumber Co.* v. *Comm.*,[41] the amount disallowed as a rent deduction remained taxable to the stockholder as dividends to the extent of available earnings. This result was also reached

(Continued on page 47)

[35] 9 TC 173, decided August 11, 1947.
[36] TC Memo, Dkt. No. 13851 decided May 14, 1948.
[37] 9 TC 219, decided August 20, 1947.
[38] 167 F (2d) 633 (CCA-2; 4-23-48), affirming 6 TCM 582.
[39] 7 TC 1129, affirmed (CCA-5; 1948) 165 F (2d) 483.
[40] 6 TCM 1237; 11-12-47.
[41] 7 TCM 454; 6-29-48.

Capital Adjustments of Securities

By Mamie Joan Feingold, C.P.A.

This article deals with the adjustments to the basis of securities and income therefrom, as required by the Internal Revenue Code, Regulations and rulings. Capital adjustments, or capital changes, are required when a corporation issues non-taxable stock dividends or rights, pays a dividend partially or wholly non-taxable, or exchanges securities. These and several other circumstances will be discussed in connection with the filing of the Federal income tax return for the investor or trader.

Stock Dividends

Stock dividends issued to stockholders in the same class of stock are non-taxable.[1] The cost and acquisition date of the original shares are applicable to all the shares. The basis per share is reduced as follows:

	No. of Shares	Total Basis	Cost per Share
Feb. 1, 1948 Basis	100	$6,000	$60
Mar. 1, 1949 Stock dividend	50	—	
	150	$6,000	$40

If the 50 shares received as stock dividend were sold on June 1, 1949, for $45 per share, or $2250, the gain of $250 would be reported as long-term, since the holding period goes back to the date of the original shares on which a non-taxable stock dividend is received.

Stock dividends issued in a different class of stock have been held to be non-taxable where only one class of stock was outstanding prior to such dividend, and the proportionate interests of the stockholders after issuance of the stock dividend remained the same.[2] The basis of the old shares is allocable to the two classes of stock in proportion to their respective market values on the date of distribution. If 100 shares of common were purchased on February 1, 1948, for $6000, and 10 shares of preferred were received as a non-taxable stock dividend on March 1, 1949, the basis of $6000 would be apportioned as follows:

	Market Value per Share	Total	%	Adjusted Basis
100 shares Common ...	$72	$7,200	90	$5,400
10 shares Preferred ..	80	800	10	600
		$8,000		$6,000

The holding period of the preferred shares starts from February 1, 1948, the acquisition date of the shares on which the dividend had been issued.

When taxable stock dividends are received, the basis of the old shares is unchanged. The new stock is taxable as dividend income at its fair market value when made available, and that date and value are its basis for sale or exchange.

All stock dividends received in a taxable year beginning before January 1, 1936, were non-taxable. Apportionment of basis between old and new stock is to be made in such cases, except where the dividend had been re-

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[1] *Helvering* v. *Griffiths,* 318 U. S. 371 (1943).
[2] *Helvering* v. *Sprouse; Emil Strassburger* v. *Comm.;* 318 U. S. 604 (1943).

ported in income, and not thereafter excluded. (Sec. 113(a)(19) C)

Stock Rights

When a corporation plans to issue additional capital stock, rights to purchase the new shares at a stated subscription price, are sent to the stockholders of record, one right for each share. The number of rights required for the subscription to each new share is set forth in the notice. When the quotation for the stock is higher than the subscription price, the rights have a market value and are traded on the exchange. The value of each right is approximately the difference between the market value and the subscription price, divided by the number of rights required to subscribe to a new share. If two rights are required for each new share subscribed for at 85 and the stock is quoted at 95 ex-rights, the value of each right is $5, or 5% of the total value of $100, for each share plus right. A stockholder has the option of exercising the rights and subscribing to the new stock, or of selling his rights.

Generally, the rules for determining the taxability of rights are the same as those applicable to stock dividends. However, the mere receipt of taxable stock rights does not result in income and no loss is deductible if taxable rights lapse. The pertinent rules for *taxable* stock rights are:

(a) Dividend income is realized at time of exercise to the extent of the value of the new class of stock acquired over the subscription price.

(b) Ordinary income is realized at time of sale to extent of amount received. (GCM 25063, IRB 1947-10.)

(c) No adjustment of the old shares is required.

If the receipt of the rights is *non-taxable,* and they have a market value at the issue date, the basis of the old stock must be reduced proportionately if the rights are either exercised or sold. Using the example given above, the adjustment to the old shares would be made as follows:

Feb. 1, 1948	Basis, 100 shares.....	$9,000
Mar. 1, 1949	Rights received—5% .	450
	Adjusted basis of 100 shares...	$8,550

If these non-taxable rights were sold on March 1, 1949, for $500, the gain of $50 would be long-term, as the holding period goes back to February 1, 1948, the acquisition date of the shares.

If the stock rights were exercised, the basis for the new shares would appear as follows:

Mar. 1, 1949	100 rights received... 5% of $9,000 basis	$ 450
	Subscription— 50 shares @ 85.....	4,250
	Basis of 50 shares...	$4,700

The holding period for these shares starts from March 1, 1949, the date the rights were exercised.

If non-taxable rights expire unexercised, no adjustment is made to the basis of the stock, nor is loss allowable therefor. However, the basis of the old shares is adjusted and a short-term loss allowable, if the rights had been issued pursuant to an SEC order or if they were purchased for value.

Warrants are long-term options or rights attached to new issues and may be detachable or not. If the value of the warrants is determinable at acquisition, a short-term loss is deductible on expiration date if they lapse. (GCM 7420, CB IX-1, Page 80.) When rights or warrants are not exercised or sold, they should be retained as evidence thereof.

Apportionment is not required if rights were received in a taxable year beginning before January 1, 1936, and the value thereof was included in gross income as a dividend (Sec. 29.113(a)(19)-2(b)), or if received in a taxable year beginning before January 1, 1939, and the entire proceeds of sale had been reported in gross income (Sec. 113(a)(19)(B)).

Exchanges of Securities

Stock Split-up or Split-off

A split-up or split-off occurs when a corporation changes the par value of its stock and new shares are issued in exchange for the old. This is a non-taxable exchange, neither gain nor loss being recognized. The basic date and cost of the original shares apply to the new shares. The basis of the share unit is increased or decreased, as the case may be.

Reorganizations

The exchange of securities in one corporation solely for securities in the same corporation, or in another corporation, a party to the reorganization, is non-taxable if made pursuant to a plan of reorganization. The new securities take the date and basis of the original securities, allocated in proportion to the market value of each class of security, where more than one class is received.

However, gain is recognized to the extent of cash or other property received in addition to the securities. The allocable basis would be reduced by the "boot" received in excess of the recognized gain; e.g.,

Received in exchange:	
100 shares Preferred—market value	$4,800
Cash	500
Total	$5,300
Given in exchange:	
100 shares common—cost	5,000
Gain	$ 300

The recognized capital gain is $300, and the balance of $200 cash received reduces the basis of the preferred to $4,600. The holding period of the preferred shares runs from the date the common stock was acquired.

Loss is not recognized on this type of exchange, but the basis is reduced by the amount of the "boot" received. If the basis of the common had been $6,000, the adjusted basis for the preferred would be $6,000 less $500 cash received, or $5,500.

However, if the corporation has earnings or profits accumulated by it after February 28, 1913, the distribution of cash or other property in connection with a non-taxable exchange will be deemed to be a taxable dividend to the extent of such earnings. (Sec. 112(c)(2)).

Gain or loss is recognized when securities are exchanged, not pursuant to a plan of reorganization, for securities of the same or another corporation, and there is a change in the interests of the holders. The fair market value of the securities received on the date of exchange is the selling price reportable for the securities exchanged. These values are the basis for the new securities, and their holding period runs from that date.

Dividends

A portion or all of a dividend received may be non-taxable if it is a liquidating dividend or is paid from:

- Earnings or profits accumulated before March 1, 1913
- Appreciation in value prior to March 1, 1913
- Depreciation reserve
- Portion of depletion reserve based on a March 1, 1913, valuation, which was in excess of the depletion based on cost

and there are no earnings or profits accumulated since February 28, 1913, available for distribution, or earnings or profits for the taxable year.

The non-taxable portion of the dividend is excludible from gross income and the basis of the stock is reduced accordingly. When the stock is sold, only the adjusted basis is allowable, even though the entire dividend had been included in gross income in prior years. Stockholders should retain the notices from the corporations advising the non-taxability of certain dividends. These notices are helpful in checking the portion of the current year's dividends which are non-taxable.

Distributions in payment of dividends from appreciation in value of property existing on March 1, 1913, are exempt from tax even if in excess of the basis.[3]

Regulated investment trusts indicate a portion of their dividends as long-term capital gain. This reduces the amount includible in ordinary income, and 50% of the amount so indicated, is reportable as capital gain. The basis of the shares is not reduced.

Liqudating dividends are treated as payments for stock. In the case of partial liquidating dividends, gain is not recognized until cost is recovered, and is reportable as capital gain. Loss is deductible when the final distribution is received. In one case, the loss was allowed in year in which the liquidation was practically completed and only a nominal reserve to pay expenses had been retained.[4]

A distribution in complete cancellation or redemption of a part of the capital stock, or one of a series of distributions in liquidation of all or a part of the stock, is denominated a distribution in partial liquidation (Sec. 115 (i)).

Gain or loss from a partial liquidation is treated the same as in the case of a complete liquidation, except that in the liquidation of a subsidiary by a parent corporation, the distributions to the parent corporation may be tax-free if the following statutory requirements are met:

(a) The parent corporation owned at least 80% of the voting stock and 80% of all other classes of stock (except non-voting stock which is limited and preferred as to dividends) at the date of adoption of the plan to liquidate until receipt of the property, and not any greater proportion during such period.

(b) The distribution is in complete cancellation or redemption of all its stock and the transfer of property occurs within the taxable year; or

(c) The distribution is one of a series of distributions in complete cancellation or redemption of all the stock in accordance with a plan of liquidation to be completed within three years from the close of the taxable year during which is made the first of the distributions under the plan (Sec. 112 (b) (6)).

Upon the liquidation of a corporation in pursuance of a plan of complete liquidation, the gain or loss of minority shareholders must be determined without regard to Sec. 112 (b) (6), since it does not apply to the part of distributions in liquidations received by minority stockholders.

Bonds "Flat"

Bonds are traded "flat" when interest payments are in default. As the price paid includes the value of the interest in arrears, the receipt, on a subsequent date, of interest for the period prior to acquisition, is a return of capital. These amounts are not includible in gross income, but reduce the basis of the bond.[5] The same rule is applicable to tax-exempt bonds,[6] even though the income is exempt.

Where the defaulted interest received exceeds the basis of the bonds, such excess has been held to be a capital gain.[7]

The records should be clearly marked showing the dates from which interest is in default on the acquisition, and the interest dates covered by each receipt. Interest for the period subsequent to acquisition, is ordinary income. In most instances, there will be one payment allocable between capital and income.

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3 *A. Henry Higginson* v. *U. S.*, Court of Claims, 81 Fed. Supp. 254 (1948).
4 *Comm.* v. *Winthrop*, 98 Fed. (2nd) 74, 1938; GCM 21966, 1940-1 CB 130.
5 IT 3689; CB 1944, p. 65.
6 *R. O. Holton & Co.*, 44 BTA 202 (1941).
7 *Edith K. Timken*, 6 TC 483 (1947); Acq.

The basis of bonds "flat" must be reduced for interest arrears received, in computing the gain or loss on sale or exchange, even though the entire receipts had been included in gross income in prior years.

Premiums on Bonds

Bonds as used in this section, refers to bonds, debentures, notes, certificates or other evidences of indebtedness, issued by a corporation (including those issued by a government or political subdivision thereof) with interest coupons or in registered form, (Sec. 125(d)), except obligations which are the stock-in-trade of the taxpayer or includible in inventory.

The premium on a bond is the excess of its basis for determining loss on sale or exchange over the amount payable at maturity or on an earlier call date. If there is more than one call date, the taxpayer may select any interest payment date on which the bond is callable. Although amortization of bond premium has been deductible only for taxable years beginning after December 31, 1941, the premium is apportioned over the period from the basic holding date to the maturity or call date. If the bonds are not called on or before the date selected, the excess of the call price over the face amount of the bond should be amortized from such date to the maturity date. (GCM 24078 CB 1944-1, p. 284.)

A taxpayer, other than a corporation, may elect to claim such deduction for wholly taxable and/or partially taxable bonds. A corporation may make the election only for wholly taxable bonds. Such an election is applicable to all bonds of this class held and subsequently acquired, and is binding for subsequent years, unless the Commissioner approves an application to revoke such election.

The amortization deduction may be computed in accordance with the method prescribed in Sec. 29.125-3 of the Regulations or a method regularly employed by the taxpayer, if such method is reasonable. A statement showing the method of computation should be attached to the return in the year of such election.

The interest received or accruable is includible in gross income, and the amortization is allowable only as a deduction. A taxpayer electing the standard optional deduction, may not claim amortization in addition thereto. The basis of the bond is reduced by the amortization deductible from the date of such election.

A taxpayer, whether on the cash or accrual basis, is not required to amortize the bond premium in a taxable year in which interest is not received or accruable. However, the deduction for amortization will be permitted, unless the approved method used by taxpayer does not provide for amortization in such years. (Sec. 29.125-7.)

Capital expenditures in connection with the acquisition of a bond are to be added to the amortizable premium. A taxpayer under whose regularly employed method such capital expenditures are not treated as being part of the bond premium for purposes of amortization may, but is not required, to treat these expenditures as being part of the premium.

Amortization of premiums of tax exempt bonds has been mandatory for all taxpayers for years beginning after December 31, 1941. The basis must be ratably reduced, even though no deduction is allowable for the amortization of such premium.

Corporations are required to amortize the premiums on partially exempt bonds, and may take a deduction therefor. The credit in respect thereto and the basis of the bonds must be reduced accordingly.

Amortization of a very substantial premium paid for an American Telephone and Telegraph Company bond, convertible into stock at the holder's option, was held deductible in *Comm.* v. *Korell* (CCA-2, June 8, 1949) and non-deductible in *Comm.* v. *Shoong.* (CCA-9, Sept. 9, 1949.) In the *Shoong*

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A Simplified Financial Budget for Smaller Manufacturers

By Fred Rubman, C.P.A.

With the return of competitive conditions, bankers and other credit grantors may find traditional Balance Sheets and Profit and Loss Statements insufficient for their needs. Because of present high costs and erratic sales and production, these credit analysts are not satisfied with a static picture of their prospective borrower's financial position at a fixed date and a record of how he fared in past periods. They want some indication of what their customer's cash position is likely to be when loans or purchase commitments mature. Despite the speculations inherent in any forecast of future events, a simple financial budget of expected cash receipts and disbursements is the best medium for showing the credit analyst "where we go from here."

The use of formal budget procedures has become a standard practice with most large concerns, but relatively few small manufacturers maintain adequate budgetary controls. The proprietors of many small firms are practical men who have an aversion to formalized procedures and prefer their own time-tested rules of thumb. Consequently, their policies for forward planning may be haphazard and ineffective because no definite and orderly plan of action is followed. The credit and accounting professions can perform a most constructive service by encouraging these smaller business men to adopt "formal" methods whereby forecasts are made on the basis of carefully assembled facts and all budget procedures are carried out in a standardized manner. Accountants should demonstrate the hazards in "off-the-cuff" calculations and reassure the smaller business man that formalization need not result in a budget that is complicated or difficult to understand. By making all budget schedules simple, condensed, and in usual trade terminology, we can convince practical management that a formal budget is merely a common-sense analysis prepared scientifically and in technically correct form.

In order to enlist the support of practical management, the accountant should not theorize, but should cite specific instances where hastily prepared or incomplete estimates have resulted in losses. An example in point, which demonstrates the penalties of haphazard planning, is furnished by a manufacturer who turned out a most attractive item at a reasonable cost and nevertheless had a disastrous season. Lacking any adequate plan of budgeted sales and scheduled production, this manufacturer accepted orders beyond the capacity of his factory and of his financial resources. He ended his season with cancellations, law suits and ill-will. This type of illustration can go a long way toward convincing the smaller business man that every business, regardless of size, must program its future on the basis of definite, carefully conceived plans. These plans should be formalized and reduced to writing so that

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actual performances can be readily compared with budgeted expectations.

We must acknowledge, in candor, that opposition to budgetary procedures does not always originate with management. Frequently the accountant servicing smaller concerns is apathetic to the adoption of additional procedures. The larger manufacturing firms usually have well-staffed, highly specialized internal accounting departments, and call upon their independent public accountants primarily for review and consultation. On the other hand, the medium and smaller sized business will expect their outside accountants to do the work necessary to prepare a budget. Fortunately, this is not too difficult in actual practice because such firms often consult their accountant on questions of managerial policy so that he usually understands his client's operations, both financial and physical. Thus, in addition to his function as an independent auditor, the accountant for the smaller firm acts as a "visiting comptroller" and is, therefore, particularly well qualified to install proper budgeting procedures on a practical basis with a minimum expenditure of time and effort.

The purpose of this article is to present a simple operating cash budget as a guide to the accountant serving smaller manufacturing firms, and to discuss briefly some of the techniques involved in its preparation. The installation and maintenance of a simplified cash budget should not impose a great burden on the accountant if two conditions are present. First, the accountant should have a comprehensive understanding of his client's business as a whole and specific knowledge of its manufacturing procedures and selling policies. Second, where a variety of items or styles are produced, the client must maintain reasonably accurate cost calculations for each item or style. These calculations are usually made on sheets or cards in a form to meet individual requirements, but the following specimen will suggest the usual contents:

Cost Calculation Card

Gross Selling Price		$xx.xx
Less: Trade Discounts		x.xx
Net Selling Price		$xx.xx
Cost of Production:		
Material ("a" quantity @ $ "b")	$x.xx	
Labor	x.xx	
Payroll Taxes, etc.	x.xx	
Factory Overhead	x.xx	
Total Cost of Production		xx.xx
Gross Profit		$ x.xx
Selling, General and Administrative Expenses, (Based on ..% of estimated total net sales of $....)		.xx
Profit, Before Income Tax		$ x.xx

It should be noted that once the manufacturer begins to use cost calculation sheets, he must of necessity predict total sales volume in order to estimate factory overhead and selling, general and administrative expenses. Thus, the cost sheets are a connecting link to the financial budget, which requires a sales forecast as the first step in its preparation. Moreover, as will be discussed subsequently, budgeted cash outlays for certain manufacturing costs may be computed from the cost calculation sheets for each product. Consequently, the cost calculation sheets are a vital prerequisite if the preparation of a for-

mal budget is to involve a minimum of additional work.

At this point it should be observed that the costs reflected in the cost calculation sheets are not identical with the disbursements provided for in the operating cash budget. The latter is merely a summary of estimated cash receipts and disbursements over a period of time. In other words, the operating cash budget is a device for "merchandising cash" by estimating its flow in and out of the business. The cash budget does not consider bookkeeping adjustments such as depreciation or accruals, but provides for outlays in the specific periods in which they occur. On the other hand, cost calculations provide for depreciation and similar items and for a per-unit, proportionate share of all known expenses on an accrual basis, regardless of specific payment dates. As a result of these differences, the trends disclosed by the cash budget over a period of time will not coincide with the changes reflected by profit and loss statements at the beginning and end of the period. It follows also that the operating cash budget is not an estimated profit and loss statement. Once budgetary procedures have been installed, estimated profit and loss statements and estimated balance sheets may be prepared as refinements, but the first venture in formal budget procedure should be the adoption of a simplified operating cash budget.

The accountant's initial task in the preparation of any budget is to assemble the cost estimates and statistical records already employed by his client. It is amazing how many records of this nature are maintained, without proper coordination or effective use. The utilization of these records in the preparation of a budget should be a joint undertaking of the accountant and his client's organization. The management will then feel that it has helped create the budget and is sure to make a greater effort to understand and use it.

The techniques involved in setting up an operating cash budget are demonstrated in the following specimen budget prepared for a hypothetical manufacturing firm with a capital of $120,000, consisting of:

Cash		$ 10,000
Accounts Receivable		58,000
Inventory		50,000
Plant and Other Assets		28,000
Total Assets		$146,000
Accounts Payable	$16,000	
Income Taxes Payable	10,000	
Total Liabilities		26,000
Capital		$120,000

The manufacturer has two operating seasons: December to May, with an estimated sales volume of $500,000, and June to November, with estimated sales of $600,000. The company's sales terms are 3/10 e.o.m., n/30. The firm expects to collect 80% of the billings on discount terms by the 10th of the month following billing; one-half of the remainder (10%) on a net basis during the balance of the month following billing; and the remaining balance (10%) during the second following month. The production cycle is estimated to be one month. The company purchases merchandise on terms of 2/10, n/60, and regularly takes discounts on the tenth day after invoice date. Approximately two-thirds of the purchases of any month are due for discount within the month, and the remaining third is scheduled for payment the next month.

Selling, administrative and general expenses for the full fiscal year which ends November 30 are estimated at $200,000, of which $90,000 are fixed expenses to be incurred uniformly throughout the year. The balance of these expenses totals $110,000 and they fluctuate with monthly sales. Expenses are paid as incurred, without discounts. Income taxes of $10,000 on the prior year's earnings are payable in quarterly installments.

The specimen budget covering the December, 1949, to May, 1950, season follows, together with a brief discussion of each item.

Operating Cash Budget
December, 1949, to May, 1950

	December	*January*	*February*	*March*	*April*	*May*
Projected Sales	$ 75,000	$100,000	$100,000	$ 90,000	$ 80,000	$55,000
Cash Available						
Cash on Hand—Beginning of Month	$ 10,000	$(28,700)	$(49,060)	$(38,640)	$(14,300)	$ 7,720
Collections on Sales (Schedule 1)	51,800	70,700	95,100	97,600	88,840	79,080
Total Cash Available	$ 61,800	$ 42,000	$ 46,040	$ 58,960	$ 74,540	$86,800
Cash Required						
Manufacturing Costs:						
Direct Material Costs (Schedule 2)	$ 49,000	$ 46,060	$ 40,180	$ 36,260	$ 33,320	$26,460
Labor (Including Taxes, etc.)	20,000	20,000	17,000	15,000	13,000	8,000
Factory Expenses	6,500	7,500	7,500	5,500	5,000	4,500
Total	$ 75,500	$ 73,560	$ 64,680	$ 56,760	$ 51,320	$38,960
Fixed Selling, Administrative, and General Expenses	7,500	7,500	7,500	7,500	7,500	7,500
Variable Selling, Administrative, and General Expenses	7,500	10,000	10,000	9,000	8,000	5,500
Income Tax Installments	—	—	2,500	—	—	2,500
Total Cash Required	$ 90,500	$ 91,060	$ 84,680	$ 73,260	$ 66,820	$54,460
Excess	—	—	—	—	$ 7,720	$32,340
Deficiency	$(28,700)	$(49,060)	$(38,640)	$(14,300)	—	—

The starting point of the budget is the forecast of sales which, of course, requires careful study. It is essentially an estimate by the management, but it must not be based on hopeful guesses. The accountant may participate in the discussions during which management considers future sales prospects for each item produced. He should check these estimates with past performances if the client is an established firm, or with previous sales records of the sales force if it is a new firm. He should also examine confirmed orders on hand and compare them with the management's scheduled sales for the near future. The validity of the budget hinges upon the sales projection. If the sales forecast is not reasonably accurate, the budget as a whole will be ineffectual regardless of the arithmetical correctness of all the other components.

The computation of collections on sales in accordance with the assumed conditions presents little difficulty. A typical worksheet follows, assuming sales of $80,000 in October and $50,000 in November, with collections conforming to the hypothetical conditions stated previously.

Estimated Collections on Sales — Schedule 1

December, 1949, to May, 1950

	From Sales of 2nd Preceding Month	*From Sales of Preceding Month*				*Total Expected Receipts*
		Discounted			*Not Discounted*	
		Gross	*Discount*	*Net*	*Net*	
December, 1949	$ 8,000	$40,000	$1,200	$38,800	$ 5,000	$51,800
January, 1950	5,000	60,000	1,800	58,200	7,500	70,700
February, 1950	7,500	80,000	2,400	77,600	10,000	95,100
March, 1950	10,000	80,000	2,400	77,600	10,000	97,600
April, 1950	10,000	72,000	2,160	69,840	9,000	88,840
May, 1950	9,000	64,000	1,920	62,080	8,000	79,080

The estimate of outlays to merchandise suppliers for direct materials can be prepared by applying the cost of required materials, per the cost calculation sheets, to the specific items comprising the anticipated sales. In computing these material requirements, consideration must be given to the length of the production cycle, the usable materials on hand at the beginning of the period and the estimated minimum quantity that should be on hand at the end of the period. The accountant should also check the budgeted expenditures for materials against actual purchase commitments. After the required merchandise purchases have been determined, the budgeted cash requirements for this purpose can be tabulated on a worksheet schedule in the following typical form. Both Schedules 1 and 2 are worksheet tabulations only.

Budgeted Disbursements to Merchandise Suppliers for Direct Material Costs — Schedule 2
December, 1949, to May, 1950

	Estimated Merchandise Purchases	Payments for ⅓ of Prior Month's Purchases			Payments for ⅔ of Current Month's Purchases			Total Payments
		Gross	Discount	Net	Gross	Discount	Net	
December, 1949	$51,000	$16,000	$320	$15,680	$34,000	$680	$33,320	$49,000
January, 1950..	45,000	17,000	340	16,660	30,000	600	29,400	46,060
February, 1950.	39,000	15,000	300	14,700	26,000	520	25,480	40,180
March, 1950 ...	36,000	13,000	260	12,740	24,000	480	23,520	36,260
April, 1950	33,000	12,000	240	11,760	22,000	440	21,560	33,320
May, 1950	24,000	11,000	220	10,780	16,000	320	15,680	26,460

Labor costs should be estimated by the management and checked by the accountant against the payroll records and cost calculation sheets. The smaller manufacturer usually does know his labor costs, but the accountant's critical review is required to insure that management has not overlooked any items, has considered the expected level of production, and has provided for extraordinary events. In estimating disbursements for labor, allowances must be made in applicable periods for paid holidays, vacation pay, payroll taxes, union funds, insurance, etc. It is sometimes helpful, for comparative purposes, to obtain estimates from other manufacturers for performing similar work on a contract basis.

Factory overhead items are usually estimated on the basis of prior experience or on the basis of the costs of comparable firms. The budgeted variable factory expenses must, of course, be related to the expected production. The operating cash budget provides for all cash outlays during the period, even though only part thereof might be applied on an accrual basis. This covers items such as extraordinary factory repairs and maintenance, etc. No provision is made in the financial budget for depreciation or other non-cash charges.

In providing for selling and administrative expenses, the accountant should study carefully the personnel requirements of each department so that he may plan the overhead load realistically. Budget discussions frequently provide a good opportunity to review items such as executive compensation, profit sharing arrangements, etc. Outlays for such items as officers' life insurance, taxes, etc., must be provided for in full during the periods when payment is due. Check lists based on previous profit and loss statements of the client or of similar firms should be utilized to assure provision for all known expenses.

In preparing the foregoing specimen budget, it was assumed that there would be no capital outlays during the period. Full provision on a cash basis would have to be made in the financial budget for any capital expenditures.

The calculated excess or deficiency of budgeted cash is the end result of the financial budget. In the illustrative budget, our hypothetical manufacturer would require temporary financing dur-

(Continued on page 59)

Internal Control, Internal Auditing and Effect on Audit Program

By T. Reginald Cloake, C.P.A.

There have been numerous definitions propounded for "internal control" and since it is not the purpose of this discussion to arrive at the perfect definition, if one could be obtained, it will suffice to describe it generally as a form of procedure within an organization which offers a method of checks and balances to the extent of discouraging theft, promoting accuracy and reliability of the accounting data, and developing general operational efficiency. To the extent that such control accomplishes these ends, it follows that the necessary review by the independent auditor is lessened. His certain "musts" in auditing (as, for example, confirmation of bank balances, examination of securities, confirmation of accounts receivable, etc.) cannot be eliminated, but the extent of his tests may be minimized, especially insofar as they concern operations. In fact, the existence of a substantial degree of internal control is what makes possible the successful conclusion of independent audits of very large concerns. The accounting regulations of the United States Securities and Exchange Commission explain this point:

> "In determining the scope of the audit necessary, appropriate consideration shall be given to the adequacy of the system of internal check and control. Due weight may be given to an internal system of audit regularly maintained by means of auditors employed on the registrant's own staff. The accountant shall review the accounting procedures followed by the person or persons whose statements are certified and by appropriate measures shall satisfy himself that such accounting procedures are in fact being followed."

The role played by the internal auditor in maintaining control procedures will be discussed in a subsequent paragraph.

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Evaluating Effectiveness of Internal Control

In evaluating the extent of internal control some certified public accounting firms employ questionnaires several pages in length. In such instances it is concluded that the questionnaire form is so inclusive that where all questions appearing therein are answered satisfactorily, the system of control is complete. Other firms do not use specific questionnaires but have the system of control evaluated by the senior accountant during the course of his examination. Should he observe laxity in control, or shortcomings in procedures, he will note completely the shortcomings and will not specifically write up the procedures for control where they do exist. The danger in the use of the questionnaire alone, without continued observance during the course of the audit, is that practices, although answered in the affirmative in the questionnaire as the result of questioning the concern's employees, may be entirely different in actual operation. In any event, the evaluation of an internal

control system should be done by an experienced and well trained accountant. It should not be delegated to assistants.

The Internal Auditor in Internal Control

The place of the internal auditor and his staff in the development and maintenance of internal control is of especial importance. In fact the internal auditor is an integral part of the entire internal control system. A special report entitled "Internal Control", issued this year by the Committee on Auditing Procedure of the American Institute of Accountants includes the following on the internal auditor's function:

> "An internal audit staff may be used not only as a check on the accuracy of the accounting data and the safeguarding of the company's assets, but also as an instrument of management in determining adherence to prescribed policies. Thus, the audit activities should be widespread, covering all departments."

Adherence to presrcibed policies refers to the maintenance of procedures which in themselves are a part of internal control. The report continues:

> "The review and appraisal to be useful to management must be unbiased—free from any departmental influence as to the scope of the audit program and the method of reporting thereon. The internal auditor should be free to advise management of any deficiencies noted, without fear of reprisal from any department heads. His relationship to the department head should be clearly set forth by management to avoid any misunderstanding as to their relative positions. Under such conditions the internal auditor is in a position, without any limitations, to serve management in the detection of frauds, weaknesses in procedures and in the clarification of policies on a company-wide basis.
>
> "In many instances, while the size of the organization may warrant segregation of the internal audit function, the economic employment of personnel of the quality compatible with complete independence may not be practicable. Under such conditions the question often arises as to the propriety of incorporating the internal audit function into the sphere of the controller. An arrangement of this sort is generally regarded as satisfactory, assuming independence of the accounting and auditing function at the next lower level."

This emphasizes the need for independence in review and the maintenance of greater than arm's length relationships with other employees. The fact that the internal auditor and department head both serve the same concern makes it difficult to make uninfluenced criticisms. Lunching together, attending parties together, etc., further contributes to non-independence. However, it is not impossible for the internal auditor to maintain a constructive, impartial and critical attitude. Educating executive and administrative employees as to the benefits of constructive reviews of their departments as an aid to the promotion of efficiency does help. Rotation of internal auditors, the assignment of auditors to other than their home plants, and other techniques are employed to promote maximum independence.

Independent Auditor's Reliance upon Internal Auditor's Review

After concerns have gone to great length to establish and maintain internal auditing departments, some complain that the independent certified public accountants do not give full recognition to their reviews, do not adjust their programs accordingly, and do not avail themselves of their compiled information. There is something to be said on both sides of this question. The Institute of Internal Auditors, Inc., New York City Chapter, in a recent news bulletin stated the position of the internal auditor as determined from a questionnaire sent to its membership:

> "Perhaps the most disappointing replies received were those relating to the interrelationship between public accountants and internal auditors. There are many leading firms and individuals in the field of public accounting who still either do not or will not recognize the role of internal auditing.
>
> "The question was asked: 'Does a close working relationship exist between your company's Internal Auditor and its Public Accountant?' One hundred and five companies answered this question, and of these

22 answered in the negative. This failure is believed to be due largely to a lack of understanding of modern internal auditing on the part of men in the public accounting profession. The Institute of Internal Auditors should take active steps to correct this situation."

Perhaps we as certified public accountants should take the initiative. The bulletin continues:

"This question was asked: 'In the opinion of your company's Public Accountant, could he issue an unqualified certificate if the company did no internal auditing?' The direct answers were divided almost 50-50 between Certified Public Accountants who said they could issue an unqualified certificate and those who said they couldn't if there was no internal auditing in a given company. Does this mean that the Certified Public Accountants answering in the affirmative do more work than is really necessary in companies having internal auditing staffs? Or, and this appears more likely, does it mean that these Certified Public Accountants fail to understand just what work is performed by the internal auditors? Internal auditing is an essential factor in internal control in any large or complex company, and if this function is not performed, the certificate ought to be qualified to reveal the fact that the system of internal check and control is not complete."

As previously stated, the existence of internal auditing and other procedures for internal control make possible the audit of very large concerns, and enable an unqualified certificate to financial statements to be issued.

Coordination and cooperation between the independent auditor and the internal auditor is much to be desired. It is born of an appreciation of each other's functions and a cooperative spirit in the solving of respective problems. In order that the independent auditor may place the maximum reliance upon the effectiveness of the reviews made by the internal auditor, the internal auditor's program of audit should be developed in close cooperation with the independent auditor, giving the latter an opportunity to criticize constructively where he believes reviews are inadequate or procedures lacking. The internal auditor's program, when once established and used, should be maintained as a permanent record, including in it the dates when specific reviews were performed and the initials of the internal auditor who did the reviewing. The internal auditor's reports and working papers should be offered to the independent auditor for his information or use. Where the independent auditor suggests the elimination of duplication of effort by having the internal auditor prepare analyses of accounts or other data for his use, then appropriate carbon copies should be prepared for him. If special forms of analyses are desired then these should be laid out in cooperation so that, although serving different purposes, the working papers may be of maximum use to both.

Some independent auditors might be criticized for maintaining a haughty, indifferent and superior attitude; fortunately such individuals are in the minority. Such attitudes are entirely unjustified and personal, they are not representative of the certified public accounting profession, but reflect only the shortcomings of the individual auditor.

A lack of understanding between the internal and independent auditor may arise because the internal auditor does not appreciate that the independent auditor has certain "musts" in his program, as mentioned before. The internal auditor's attitude may be such that he resents the independent verification of something which he knows is correct. On occasion the independent auditor will refuse to rely upon the internal control effected by the internal auditor where he learns that the internal auditor's time has been utilized to a great extent by the accounting department in special studies, systems work, preparation of statements, etc. Sidetracking of the internal auditor to other than his principal function is often likely to occur. This is especially so because the internal auditor is usually a highly skilled accounting technician who can help out in special accounting problems. In smaller concerns with less well organized internal auditing depart-

ments, the internal auditor might find that he spends so much time doing special jobs for the Treasurer that he has little time for internal auditing.

Conclusion

Let us not lose sight of the goal in any auditing procedure, the completion of the review and the appropriate presentation of findings in a manner that is economical, expeditious, accurate, and complete. We, as independent accountants, cannot do less than certain required minimum of independent audit, but we must recognize internal controls where effective and adjust our programs accordingly. The exercise of mature judgment is required in determining the extent of examination and whether the interests of stockholders and creditors justify the time and expense involved in pursuing any particular line of independent inquiry.

Because fullest cooperation is not always existent, it behooves both internal and independent auditors to subject themselves to self-analysis and criticism and to mend their ways if they find shortcomings. Auditors are professionally concerned with the criticism of others, yet, being human, they will have difficulty in making unbiased criticisms of themselves.

AN ADIRONDACK VIEW

Debit, Credit and Balance. Back in the twenties we studied accounting systems in a course by that name in the Springfield division of Northeastern University. And we really had to study in order to make the grade—because "we" were the teacher.

The pupils were all employed by day, mostly in offices. The teaching system was that the left side of the class answered the questions of the right side. All the teacher did was add to the supply of questions, oversee the resulting battles, and keep the trains of thought on the track.

For the question "What should be included in any accounting form?" the answer was, "The information that is habitually needed." Then came the question "What information is most often used from an account in any general ledger?" The answer was "The balance."

After twenty odd years, along came Thanksgiving, 1949, and with it came a niece who brought along an illustrative bookkeeping problem from her class in a top-level secretarial school—in the New York City area, no less! Shades of St. Peter! The ledger account had debits in the left half, credits in the right half, and no column for the balance—the pre-1890 model, which could be well named the "try-to-find-the-balance" model.

And so we wonder if the educational end of the accounting profession isn't too slow in going forward. Look, thou, unto the automobile, it changes every year; and the 1949 model knoweth not the 1920 model—except for four wheels! And the accountants, are they not still in the last century with the little fellows? Only this morning a phone call tells about a single entry system bringing trouble from the income tax boys. Are we driving 1949 Cadillacs and letting schools and clients ride with 1915 Stevens Duryea systems and methods? Shame on us!

LEONARD HOUGHTON
Of the Adirondack "Chapter"

New York State Tax Clinic

Conducted by BENJAMIN HARROW, C.P.A.

Interrelation of Real Estate and Business Corporations

Sec. 209.4 of Article 9A provides that corporations subject to tax under Section 182 (as a real estate corporation) shall not be subject to tax under Article 9A (as a business corporation). But Section 211.4 provides that whenever substantially all the capital stock of a real estate corporation is owned or controlled directly or indirectly by a business corporation, or whenever substantially all the stock of the real estate corporation and a business corporation is owned or controlled, directly or indirectly, by the same interests, and in either case any material part of the property of the real estate corporation is used or occupied in the conduct of the business of the business corporation, the real estate corporation *shall become taxable* under Article 9A, and the real estate corporation and the business corporation may be required or permitted to make a combined report under Article 9A. In addition, the exemption under Section 209.4 *shall be annulled,* and the real estate corporation shall be taxable under Article 9A as a business corporation.

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The foregoing mandatory language making the real estate corporation taxable under Article 9A, if it falls within the conditions prescribed therein, was put into the law by the 1948 legislature (Ch. 603, Laws of 1948). The change is applicable to reports for years beginning after July 31, 1947. Many taxpayers are beginning to feel the full impact of this section and are asking whether the Commission can do that to them.

The question thus raised is a constitutional one. It is a question of the extent of the power of the state to tax. The state Constitution (Art. XVI, Sec. 4) provides that

> "where the state has power to tax corporations incorporated under the laws of the United States there shall be no discrimination in the rates and method of taxation between such corporations and other corporations exercising substantially similar functions and engaged in substantially similar business within the state."

Other than this provision, which is not applicable to corporations organized in New York or the other states, there are very few restrictions placed upon the power of the legislature to levy taxes. However there are federal limitations on the taxing power of the state. One of these is Section 1 of the 14th Amendment, the due process clause. This clause prevents a state from levying a tax upon a basis that is palpably arbitrary, capricious, or unreasonable. One of the underlying principles of taxation is equality. All taxpayers within a designated class must be treated equally. Otherwise the tax is discriminatory and unconstitutional. Hence classification of taxpayers becomes important.

The franchise tax law of New York puts real estate corporations in one class and business corporations in another, and taxes each class of corporation differently. That is a proper basis of taxation, since there are sufficient differences between real estate corporations and business corporations to segregate them for tax purposes.

If the constitutionality of Sec. 211.4 is to be questioned, it must be done on the basis that this section creates a discriminatory classification between a real estate corporation interrelated with a business corporation in the manner prescribed in the section and a real estate corporation without such interrelationship. Are there enough differences between two such corporations to warrant treating the former as a business corporation taxable in one way (under Article 9A) and the latter as a real estate corporation taxable in a different manner (Sec. 182)? Or is the setting up of such differences for tax purposes a discrimination against a real estate corporation that is palpably arbitrary, capricious, and unreasonable? Can the exemption given to real estate corporations under Sec. 209.4, taking them out of the class of business corporations, be annulled under Sec. 211.4 on the basis of the interrelation of stock ownership with that of a business corporation and the use of the property of the real estate corporation? Are those distinctions sufficient to make the two real estate corporations different for tax purposes?

If the answer is that there is a distinction without a difference, the tax against the real estate corporation under Article 9A amounts to the taking of property without due process of law and is unconstitutional. A taxpayer that questions the validity of Sec. 211.4 would first file a claim for revision (Form 7 CT) and, after a formal hearing and determination by the Tax Commission, bring an action for review by the Supreme Court and thereafter there would be a determination by the Appellate Division, to which tribunal the proceedings are transferred. The action then may be appealed to the Court of Appeals. Since the issue raised is one of constitutionality, a federal question, a review by the U. S. Supreme Court may be granted.

Deductible Losses

A taxpayer collects antiques as a hobby. Occasionally he will sell an item, usually at a profit. The taxpayer buys what is represented to be an original Rembrandt and later discovers that the painting is not a genuine Rembrandt and that it has only a nominal value. Has the taxpayer sustained a deductible loss?

Section 360(4) of the income tax law allows as a deduction a loss sustained during the year, if incurred in a trade or business. Section 360(5) provides for a deduction of a loss sustained if incurred in a transaction entered into for profit, even though the transaction is not connected with a trade or business. In the foregoing case, the loss has not yet been realized since there is no completed transaction. No loss is sustained until there has been a realization through a sale or exchange. But assuming that the painting were sold, the loss could not be deducted under the above provisions.

Section 360.6 provides for a deduction of a loss not connected with a trade or business if it arises from fire, storm, shipwreck, or other casualty or from theft. In the above case, the loss does not come under any of the enumerated categories. It is not a casualty as that term is used in this provision. A casualty covers such things as accidents, explosions, floods, and even an unprecedented drought.

The loss may possibly be classified as a theft. That term under the New York Penal Law means the wrongful taking from the true owner of "any money, personal property", etc. Under the facts submitted, a fraud has been perpetrated as a result of which money was taken wrongfully. If that can be classified as a larceny, the tax law permits a

deduction under the theft provision. There does not seem to be a case in point.

A deduction for the loss might come within the sale or exchange provisions of Sec. 350.15, but the painting would have to be sold to establish a realization of the loss. The state law, it should be remembered, permits a deduction for a loss resulting from the sale of a personal residence and presumably that provision would apply likewise to any other personal capital asset. Such a loss however would come under the capital gain and loss provisions of the law (Sec. 351) and the loss could be offset only against capital gains, with a possible carry-over for five succeeding years (Sec. 350.19). A loss resulting from theft would be deductible in full from gross income.

What Constitutes Carrying on an Unincorporated Business?

A & B carry on a business as partners. They sell their interests in the partnership to C & D at a profit. Is that profit subject to the unincorporated business tax?

The first point to be settled is whether the sale of the interests in the partnership can be separated from the sale of the net assets of the partnership. When the partners sell their interests in the partnership are they really selling the assets that establish the value of the partnership interests? Under the Internal Revenue Code it is now definitely settled that a partnership interest is a capital asset, separate and distinct from the partnership assets. A partner does not have a direct interest in partnership assets. His interest is in the surplus that is left after all debts have been paid. So a personal creditor of a partner has no rights against specific partnership assets. His rights may be asserted against the partner's interest in the partnership. To that extent a partnership is treated as a separate entity. It is thus possible for a partnership to dispose of specific assets for the benefit of the partnership or for a partner to dispose of his interest in the partnership.

Sec. 386 of Article 16A of the Tax Law defines an unincorporated business as any trade or business conducted or engaged in by an individual, partnership, etc. Article 4 of the official questions and answers indicates that liquidating a business by selling the assets, distributing the proceeds and winding up the affairs of a business is not carrying on an unincorporated business. Income from dealing in property "growing out of the ownership or use of or interest in such property" is subject to the unincorporated business tax, if such income is connected with the carrying on of the unincorporated business (Art. 8—Official questions and answers). Carrying on a business and selling a business are two different activities. The sale of a business or an interest in the business is not a part or function of carrying on a business. It is the opinion of this editor, therefore, that the profit resulting from the sale of the partner's interest in a partnership cannot be subject to the unincorporated business tax.

Tax on Cigarettes

In the State Tax Clinic for August, 1949,[1] we called attention to the fact that cigarettes purchased outside the state are nevertheless subject to tax in New York. President Truman has just signed a law requiring a seller who ships cigarettes in interstate commerce to anyone but a distributor to report the sale to the tax administrator of the state to which the cigarettes are sent. The penalty for a failure to do so is imprisonment up to six months, or a $1,000 fine, or both. Of course, the tax administrator will in this way be able to bill the purchaser for the state tax. No notice is required if the cigarettes are sent as a gift. Apparently, this is the first time the federal gov-

[1] Page 511.

ernment is giving its assistance to state taxing authorities in the collection of a tax. The constitutionality of the law will probably be tested in the courts. Every sale must be reported except a sale to a distributor. On October 23, 1949, the Tax Commission issued a ruling that an individual buying untaxed mail order cigarettes must file a tax return on a form that he is required to procure and pay the tax within 24 hours of the receipt of the cigarettes.

Unemployment Insurance Tax Credits

For the past two years taxpayers have been able to reduce unemployment insurance tax contributions through credits authorized by the legislature (merit ratings). Benefits paid under the law have been heavy during 1949, and the surplus in the fund may drop below the minimum required before any credits may be granted. There may therefore be no tax credit[2] for the fiscal year beginning October 1, 1949.

Gross Receipts Tax—Allocation of Receipts from Interstate Commerce

Last month, we pointed out that the Gross Receipts Tax law recognizes the effect of an interstate element in a transaction and, therefore, subjects to tax only that part of the receipt which is attributable to the doing of business in the city. The comptroller has therefore established methods of allocation for such receipts, to determine a fair apportionment to the city of receipts from interstate commerce.

The formula used is based upon three factors, property, wages and salaries, and receipts. The first factor is the ratio of the value of real and tangible personal property employed in business in the city to the total value of all such property within the United States. The second factor is the ratio of the total amount of wages and salaries paid to officers and employees who work in or from a place of business located in the city to the total amount paid to all officers and employees within the United States.

The third factor as stated above is receipts, but these are first classified into receipts from sales in foreign commerce, non-allocable and non-taxable receipts, wholly taxable receipts, and receipts from sales in interstate commerce subject to allocation. Sales in foreign commerce and non-allocable and non-taxable receipts are eliminated in their entirety from the receipts factor. The receipts factor then becomes the ratio of wholly taxable receipts plus one-third of the allocable receipts to wholly taxable receipts plus the entire allocable receipts. The three percentages determined for the three factors are then added together and averaged. The resulting percentage is subject to a ceiling and a floor. The actual average percentage may not exceed 66⅔% and the minimum average percentage may not be less than 33⅓%.

A wholly taxable receipt is one made by a New York City vendor where the goods are shipped from the vendor's factory or warehouse in the city directly to the purchaser at a point within the city or even at a point within the State of New York. If the purchaser is located outside the State of New York, the receipt is a wholly taxable one if delivery is made to the purchaser or his representative anywhere within the State or City of New York. If a seller maintains an office, agency or representative in the city and ships goods from his factory or warehouse located within the state to a point within the city the receipt is likewise considered to be wholly taxable.

An allocable receipt is one made by a New York City vendor to a purchaser outside the State of New York

[2] Since writing this note, the announcement has been made that no credits will be granted for this coming year.

where the goods are shipped from the seller's factory or warehouse in the city directly to the purchaser outside the State of New York. A receipt is also allocable if made to a purchaser within the city by an out-of-city business house maintaining an office, agency or representative within the city, if the goods are shipped from the seller's factory or warehouse outside the state directly to the purchaser within the city.

A non-allocable and non-taxable receipt is one arising from a sale where both the shipping and the delivery of the goods are entirely outside the City of New York. This category includes delivery to a purchaser within the State of New York but outside the City of New York.

Where direct delivery is made to a purchaser in New York by a New York City vendor from a third party, the latter being outside the city, the receipt is wholly taxable. But if the purchaser is located at a point outside the city, the receipt is non-allocable and non-taxable.

Where a New York City vendor enters into a sales contract with a New York City purchaser for delivery of goods to a third party, the receipt is wholly taxable if delivery is made from New York City directly to the third party located either within the City of New York or within the State of New York, or even outside the state. The receipt is non-allocable and non-taxable if delivery is made from an out-of-city factory or warehouse owned or operated by the vendor to a point outside the city. It is likewise non-allocable and non-taxable if the delivery is made from a third party's source of supply, where the source is located outside the city and the purchaser is located outside the city.

Double Taxation of Dividends

The treatment of dividend income highlights sharply one of the major inequities in the present income tax law. The source of the dividend is generally the net income via the surplus of a corporation. This net income is subject to a corporate income tax and the dividend is of course not deductible in arriving at the taxable net income of the corporation. Nevertheless the dividend is fully taxed to the individual as ordinary income even though it has already been taxed as part of the taxable net income of the corporation. A corporation may finance itself through equity capital, in the form of stock, or through borrowings in the form of bonds or notes. Interest paid on indebtedness is deductible in arriving at taxable net income. This differentiation between interest and dividends, it is claimed, is unrealistic and inequitable. As a matter of fact, Congress was aware of the heavier tax burden placed upon dividend income, for under earlier tax laws such income was exempt from normal tax and subject only to surtaxes. Even under the present code a corporation receiving a dividend is subject to tax only on 15% of such dividend.

Various plans have been suggested to minimize the present inequity. Perhaps the fairest method would be to allow a deduction from gross income for dividends paid during the taxable year, thus treating the dividend in the same way that interest on bonded indebtedness is treated. If the loss in revenue would be too great the corporate tax rates could be increased. This is probably not an opportune moment to suggest tax decreases. Nevertheless the inequity demands a remedy, which if followed through could result in a greater flow of venture capital and better financing of corporate capital through the issuance of stock rather than bonds, etc.

Another plan for relief is to exempt dividend income from tax in the first bracket of combined normal and surtax. Still another is to subject dividends to a flat rate of perhaps ten percent, the tax to be withheld by the corporation.

While this situation has been agitat-

ing the business community in relation to federal income taxation, the arguments for more favorable treatment of dividend income apply equally to state income taxation. Under Article 9A a corporation may be subject to franchise tax under the net income basis. Dividends are not an allowable deduction under this basis, and the dividend is taxable to an individual stockholder as ordinary income under the state income tax law. A corporation receiving such a dividend will be taxed upon 50% of it as investment income or exempt from tax, if the income can be classified as subsidiary income. Under Sec. 182, a real estate corporation is itself subject to a separate tax of 2% on dividend distributions and of course the stockholder is again subject to an income tax on the same dividend. Perhaps the state could lead the way in affording relief to the double burden placed upon dividend income.

Deduction for Depreciation

We recently commented on the rather novel proposition that depreciation on depreciable assets should be computed on replacement values. Behind this proposition was the attempt on the part of businessmen to obtain a greater deduction for depreciation for tax purposes. In part, the business community felt the need for a larger depreciation deduction as an encouragement to invest surplus funds and new capital in plant replacement. Investment in capital equipment is desirable and should be encouraged. Congress could assist such a movement by increasing the allowable deduction for depreciation. This was done during the war through the allowance for amortization of war facilities. If depreciation deductions were doubled, the loss in revenue would not be severe since such assets would be fully depreciated in a shorter time, after which the taxpayer would receive no further deductions for depreciation on these assets. Increased allowances for depreciation would ease the burden and expense of tax administration and tax controversy considerably, since disputes concerning problems of depreciation would be considerably minimized. We urge the Tax Commission to take the initiative in establishing increased depreciation rates for franchise and income tax purposes.

Application for Consent to Dissolution

In the November issue of the New York State Tax Clinic (p. 715), we discussed some of the problems that trouble taxpayers when they seek consent to dissolve. We referred particularly to questions 8 to 12 that deal with final audits and determinations by the Treasury Department. Apparently we stirred Prentice-Hall into considering the same question. In their Report Bulletin 10 of the New York State Tax service dated November 21, Prentice-Hall comments editorially on Complete Disclosure on Dissolution Application. Prentice-Hall is apparently in agreement with our conclusions, emphasizing as we did that full disclosures should be made to all questions on appropriate riders. Prentice-Hall points out that the "questions are designed to disclose how much is available to satisfy taxes, against whom and against what property the tax lien can be enforced in the future, and whether it is likely that a federal change will come through meaning more state taxes due." Prentice-Hall agrees with us that the state will not hold up dissolution because of the possibility of future federal changes, particularly if adequate reserves are set up to take care of contingent tax liabilities.

Federal Accrual of Additional 1% New York Franchise Tax Return

In the November, 1949, issue of the State Tax Clinic (p. 713) we discussed the recent Treasury Department ruling[3] that the additional one

[3] I.T. 3968.

per cent tax for years ending July 31, 1948, to and including December 31, 1948, is accruable and deductible for the taxable year following the 1948 fiscal year. How is the franchise tax deduction to be treated if the taxpayer had actually accrued the franchise tax at the 5½% rate for fiscal years ending between July 31, 1948, and December 31, 1948? Samuel Jolles of Freeman & Davis had this problem and he has submitted to me correspondence with the Commissioner of Internal Revenue which indicates that I.T. 3698 referred only to corporations that had accrued the deductions at the rate of 4½%. Presumably if the deduction had been taken at the rate of 5½% it will be allowed, although the Treasury Department letter does not say so in so many words. It suggests that a formal specific ruling on this point be obtained by the taxpayer.

Tax Problems in Real Estate Operations

(Continued from page 26)

in another decision, *Ruben Simon*,[42] which suggests a very practical tax saving idea. In that case a partnership of two brothers owned realty which was rented to a corporation in which the brothers owned all the stock. Rental was based upon 6% of gross sales of the corporation, but the Commissioner found that 6% was an excessive rental. Anticipating a disallowance, the partnership agreed in the following year to refund any portion of the rent disallowed as a deduction to the corporation. This agreement was made after the close of the partnership's fiscal year. Despite testimony of an oral agreement before the close of the fiscal year, the Court held that the refund in a subsequent year does not retroactively reduce the distributed income of the partnership in a prior year.

Although the conditional agreement was made too late to reduce the stockholder's individual income, the case suggests the possibility that a corporation renting property from its principal stockholder should enter into a conditional agreement each year for a refunding of any portion of the rent declared excessive. If a portion of the rent is disallowed as a deduction to the corporation, the stockholder could arrange to protect himself by having the amount refunded so that he is not taxable on the excess. Reliance should not be placed too heavily on this plan since the courts are not in complete agreement as to the taxability of income subsequently refunded.

There are other provisions which can affect real estate transactions such as selling property on a deferred or installment payment plan, the distribution of property which has appreciated in value as a dividend in kind to avoid a tax by the corporation on the appreciation in value and the control of real estate sales to take all losses in one year and gains in another year when Sec. 117 (j) can be applied. The tax factor in a real estate transaction is always important and every accountant should consider and anticipate the tax consequences of every real estate transaction.

[42] 11 TC 227, decided August 31, 1948.

Accounting at the S. E. C.

Conducted by Louis H. Rappaport, C.P.A.

Changes in Forms

Last month we wrote about the revision of certain SEC forms, the adoption of one new form, and the dropping of several other forms. The SEC's action was effective when it was announced, but companies were permitted to file applications and reports on the old forms for the balance of 1949. Hereafter the new forms must be used.

The forms that were revised are as follows: 8-K, 10-K, and 10. The forms that were eliminated are: 11-K, 13-K, 24-K, 1-MD, 7, 11, 13, 15, 17, 22, 23 and 24. The new form is 9-K and is to be used for quarterly reports that were previously filed as Item 11 of old Form 8-K.

More on Revision of Regulation S-X

In our previous issue, reference was made to a proposed revision by the SEC of Regulation S-X, the Commission's principal accounting regulation in its administration of the Securities Act of 1933 and the Securities Exchange Act of 1934. The Commission had circulated a draft of its proposed revision for comment and said that it hoped to have the revised regulation effective before the end of the year. The Commission has not yet released a new draft of its proposal, and it appears unlikely that the revision will be issued in time to affect year-end financial statements.

Louis H. Rappaport, C.P.A., has been a member of the Society since 1933. He is a member of the Society's Committee on SEC Accounting as well as the Committee on Foreign Trade Accounting.

Mr. Rappaport is a partner in the firm of Lybrand, Ross Bros. & Montgomery, C.P.A's. He is also a member of the American Institute of Accountants and of the American Accounting Association.

Proposed Extension of 1934 Act

A bill (S. 2408) introduced in Congress by Senator J. Allen Frear, Jr., on August 8, 1949, would, if enacted into law, extend many of the provisions of the Securities Exchange Act of 1934 to a number of unlisted companies.

The companies affected would be those with assets of more than $3,000,000 and with more than 300 stockholders. The principal provisions affecting such companies of interest to accountants would be the requirements relating to the filing of annual and other reports (including financial statements) and those relating to solicitation of proxies.

The bill has been referred to the Committee on Banking and Currency.

Check the Underwriting Agreement

When you are called on to certify the financial statements in a Securities Act registration, make it a point to look at the underwriting agreement as soon as possible. As a part of their investigation before making a public offering, underwriters like to have as much as possible of the factual material in the registration covered by an expert review and report. As a result, they sometimes cause to be inserted in the underwriting agreement provisions affecting the certifying accountant which some-

times cause him a lot of work that he had not anticipated. He may, for example, be called on to review statistical information in the so-called "narrative" (as opposed to the financial) section of the registration, such as a classification of total sales by principal product lines or by industries. He may be asked to review payments to certain persons in excess of designated sums. These and similar provisions are not the result of any specific SEC requirements; they supplement the investigation made by an underwriter before offering securities of an issuer to the public.

Accountants are glad to assist in the preparation of the registration statement in any way compatible with their position as independent experts. Thus, some of these provisions in underwriting agreements, while outside the scope of the usual audit engagement, can be complied with, but it is important to find out about them before the agreement is executed, not at the closing when the securities are delivered and paid for. Also, if the provisions of the agreement involve a considerable amount of work on the part of the accountant, this may have an important bearing on the client's willingness to have the work done. If the cost of the additional work is disproportionate to its value, the underwriter also may be agreeable to eliminating that particular provision of the agreement.

Check the Blue Sky Requirements Too!

Long before the SEC and the Securities Act were thought of, most of the states had laws governing the sale of securities within those states. These laws are called Blue Sky laws and vary considerably as between states.

The accountant who participates in a registration engagement under the Securities Act of 1933 does not ordinarily concern himself with the Blue Sky requirements because, in most cases, a copy of the prospectus or registration statement prepared in compliance with the Federal law, when filed with the state commissions, also meets the requirements of the latter. But this is not always the case. In Illinois, for example, if the securities to be sold qualify as Class D under the laws of that state, then the balance sheet must be as of a date within 60 days, and it must be certified. This fact alone has sometimes caused underwriters to change their minds about offering securities for sale to residents of Illinois.

The "Blue Skying" of securities is usually handled by underwriters' counsel. When you start an engagement in connection with a public offering of securities, make it a point to ask counsel whether the financial statements being prepared for filing under the Securities Act will also meet the requirements of all the states in which the underwriter plans to offer the securities.

The Shoptalkers

Conducted by Lewis Gluick, C.P.A.

Philo: Gentlemen (and I include you, Kid), I've got a case for the book.

Kid: Thanks! Let's hear it.

Philo: I suppose the Shoptalker knew about it all the time, but I fell way behind on reading my services this autumn, and it just hit me. It's almost as good as the *Bercaw* case.

Star: Don't you mean the *Bercu* case? And if you do, what's good about it?

Philo: No. I meant the *Bercaw* case, and if you don't recognize it, read it tonight. But this is the case of a brother C.P.A. named Brown.

Kid: Whom did he kill?

Philo: Nobody but himself. In the face of the *O'Conner* case, he deducted the cost of a baby sitter, so his wife could help him in his office. Claimed the the sitter's pay was in lieu of what he might have paid a steno; Mrs. Brown worked for nothing.

Kid: Except every thing he made.

Oldtimer: The Kid's marriage hasn't made him any less cynical about married life. But just a moment Philo. Isn't the *O'Conner* case the one involving the school teacher?

Shoptalker: Pardon me, Phi! It is, Oldtimer. And when it came out, back in 6 TC, I commented on it at the time. Didn't believe this new case called for any more.

Oldtimer: To the extent that it is a tax case, I concur. But to me it presents a sociological problem, transcending taxation. Is woman's place in the home or isn't it? And if so why? And what are we going to do about it?

Philo: My thought, exactly! And we could discuss it all day and night and arrive nowhere except late for Thanksgiving dinner. What aroused my admiration, even more than my interest, was Brown's courage in taking the case to Tax Court. In the face of both *Bercaw* and *O'Conner,* he could hardly have hoped for success.

Oldtimer: He's had some measure of that right here, to the extent that we discuss it. Then we go back to our offices and mention it to our partners and secretaries, and then all of us talk about it after tomorrow's turkey; and gradually a lot of people hear about it. Maybe some of them will take it to their Congressmen. Who can tell what may happen?

Kid: Me! Nothing! Truman wants to raise taxes. An amendment to the Code, reversing the *O'Conner* case would reduce taxes. It would never get a hearing on the floor of the House.

Philo: Shrewd observation. But let me go on with the case, since it seems to be news to you all. This brother also took deductions for club dues and expense, and the Court upheld the Commissioner in disallowing them.

Kid: Nothing new about that. Those cases are a dime a dozen. Taxpayer always loses for lack of proof.

Philo: That's just the point. A taxpert should know that, and either have the proof or omit the deduction. I know some years back, I was managing a branch office for Asterisk & Co. It was

Lewis Gluick, C.P.A., who has been a member of our Society since 1924, has resumed the practice of accountancy in the East.

Mr. Gluick, who had been writing under the name of The Shoptalker in other magazines since 1928, recently brought his group of Shoptalkers to our columns. We would welcome your acceptance of his invitation to participate in the discussions.

set up primarily to take care of some war-babies, but the firm thought we might build up some local clientele and maintain the office, post-war. To that purpose, I was given written instructions to join the Chain Club, and use all ethical means to promote new clients. However, I had to pay my expenses there out of my share-of-profits-bonus, as distinct from my salary.

Oldtimer: Usual arrangement.

Philo: I never went to the Club except with a client or prospect, although Mrs. Philo did. I kept careful note of whom I was with. Each month, after I paid my house account, I sorted the chits. The sum of mine was charged to expense. The wife's charges stayed as personal items. And for the one year my return in Queen City was examined by an Agent, those club expenses were allowed. No argument.

Star: Did you prorate the basic dues in proportion to the Mister and Missus house charges?

Kid: Now that *is* getting it down pretty fine!

Philo: No. Those were payable in advance, and were all charged to expense; if I hadn't paid them, I would not have been allowed to incur the house charges.

Oldtimer: Sounds all right to me. You acted in a thoroughly professional way, setting a good example to all businessmen.

Shoptalker: Reminds me of a case I sat in on last winter. This man is really a high-powered money maker. He believes implicitly that to make money you've got to spend it. And how he entertains! Must have some big "in" to get the blocks of Bowl tickets he always gets. But let alone making notes in daily course . . .

Law: The Shopbook rule.

Shoptalker: . . . he wouldn't even tell his efficient secretary where he'd been, with whom or how much. She made steno notes if the information came out in conversation, but he balked like a mule at giving her daily dictation on the subject.

Oldtimer: My firm has one just like him, so let me tell the result.

Shoptalker: Go ahead.

Oldtimer: He claimed about ten thousand; the Agent gave him about two, and then he swore at you, the Agent, the Commissioner, and even his secretary, that it was a blank dark outrage.

Kid: And he didn't stop there, either. He swore if you didn't get the assessment voided in full, he'd jolly well hire someone who would, and give him the audit too.

Shoptalker: That's where I came in. He wanted to fire Noname, who called me in as consultant. I told him his case was hopeless. I don't doubt he spent more than he claimed. But the dee eff had been through the same thing twice before in five years and refused to mend his ways.

Oldtimer: Them's harsh words. No man who makes over a hundred thousand a year is a dee eff. But we are, for trying to argue with a stubbornly successful mule.

Shoptalker: Thanks for the "we".

* * * * *

Twenty-one years of Shoptalking (in print) has taught the Shoptalker a lot. One thing is that, for every one man who writes to complain or commend, to suggest or demand, there are at least 199 who intend to do so. Accordingly we answer a single inquiry here.

The copy for the Shop is from 50 to 75 days old before you see it.

Not all of the reported matter actually is heard at the Wednesday lunch club, but the luncheon table makes a convenient, almost traditional, stage-set for the conversation piece.

Thus, the talk you read in December was actually put on paper the 13th of October, and this copy was typed the day before Thanksgiving.

Happy New Year!

Three Little Words

By THOMAS W. BYRNES, C.P.A.

YEARS ago there was a popular play called "The Importance of Being Earnest." The force of that title has been brought home to public accountants through the bulletins of the accounting societies and the proceedings of the Securities and Exchange Commission. The caption of this article will undoubtedly suggest certain words to amorously inclined persons — never of course to the always practical-minded accounting practitioner — but such interpretation is far from this writer's thoughts.

For a long time the important part of an auditor's report began, "We hereby certify." The word "certify" fell into disfavor for many reasons, one of them because it created an aura of complete certainty causing an all inclusive reliance, which was not intended, upon accompanying financial statements. Credit grantors accepted the term literally and when evil days fell upon a debtor, the auditor who had used the expression in his "certificate" was severely taken to task by those who had helped finance the troubled concern. A campaign of education for users of audited statements was undertaken, and the American Institute of Accountants in its report on Extensions of Auditing Procedure (approved September, 1939) endeavored to clarify the auditor's position and the limitations of his report by stating:

> "In considering the independent certified public accountant's opinion, the reader should bear in mind one of the most important underlying concepts of financial statements, viz., that normally many of the assets of a concern are not realizable in cash, but are commonly stated at their historical cost or going concern basis at amounts which are usually greater than the realizable value in forced liquidation. Again, the true profit or loss of a concern can be determined with accuracy only over its entire existence. Therefore, in any attempt to allocate to specific periods profit or loss applicable thereto, it must be recognized among other considerations that, as many transactions are not fully completed within such periods, the result as shown must contain many estimates and approximations in the endeavor to present fairly the operating results of a period in conformity with generally accepted accounting principles."

After much consideration by accounting organizations, credit men's groups, and governmental bodies, the presently uniform "in our opinion" was adopted as the introduction to that portion of the auditor's report which will be most carefully read by all interested persons. That these three little words are to be taken seriously may be seen from a perusal of the SEC cases—two recently—in which public accountants have been censured. Also, there should constantly be borne in mind the words used, in an earlier prominent case against public accountants, by the late Justice Cardozo: ". . . Even an opinion, especially the opinion of an expert, may be found to be fraudulent if the grounds supporting it are so flimsy as to lead to the conclusion that there was no genuine belief back of it. . . ." The contention that no genuine belief could exist for the opinion was brought out in a later case where the court said: ". . . A refusal to see the obvious, a failure to investigate the doubtful, if

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Mr. Byrnes is a consultant to the accounting firm of Byrnes and Baker, C.P.A's. He was formerly an associate professor of accounting at Columbia University. He is a co-author of the text entitled, "Auditing".

sufficiently gross, may furnish evidence leading to an inference of fraud. . . ." ". . . In other words heedlessness and reckless disregard of consequences may take the place of deliberate intention."

So much has been written with respect to opinions, unqualified, qualified, negative, etc., etc., that the public accounting practitioner will do well to review frequently not only the SEC Accounting Releases, but also the Accounting Research Bulletins and the Statements on Auditing Procedure of the respective committees of the American Institute of Accountants. Study—by principals and staff members—of these, supplemented by careful reading of the discussions of them in the current accountancy publications, will lead to clearer and more definite wording in the opinion part of auditors' reports, and to greater confidence by the reader in the thoroughness of the auditor in the prosecution of the engagement.

Capital Adjustments of Securities

(Continued from page 31)

case, the decision was made on the premise that the premium was based on the excess of the market value of the stock over the subscription price provided for in the bond, rather than as an adjustment for the effective interest. A Supreme Court ruling will be required to decide this point.

Premium received on redemption of a tax exempt bond is part of the sales price and not tax exempt interest income.

Bond Discount

When tax exempt bonds have been issued at a discount, even though interest-bearing, such discount is to be eliminated from the sales price, the original discount being ratably apportioned to the holding period of each investor. This discount is deemed to be additional interest income, which is tax exempt.

However, this does not apply to purchase of bonds below par after they have been issued at par or higher. (GCM 21890 CB 1940-1, p. 85.)

Worthless Securities

The law allows seven years from the due date of a return within which a claim for refund based on worthless securities may be filed. Nevertheless, it is time-saving to take such loss on the return for the year in which it becomes worthless. When dividends on stock or interest on obligations are not being received, inquiry should be made to determine the status of the corporation and the possible worthlessness of the particular security in that year.

Losses from worthless securities are treated as losses from the sale or exchange of capital assets on the last day of the taxable year. Securities include stocks and stock rights, and also bonds, debentures, notes, or certificates, or other evidences of indebtedness, issued by a corporation (including those issued by a government or political subdivision thereof) with interest coupons or in registered form.

A loss may *not* be claimed for partial worthlessness of securities.

* * *

The tax services on Capital Adjustments or Capital Changes, contain the rulings and computations for securities which are widely held. They also include decisions and rulings pertinent to the subject and may be used as a guide for closely held securities. In some cases, it is advisable to apply to the Commissioner for a ruling.

It is recommended that the required adjustments be made currently, instead of waiting for the close of the year. The investor then has the adjusted bases of his holdings available for his guidance, and the accountant is spared arduous computations during tax time.

OFFICIAL DECISIONS *and* RELEASES

STATEMENTS ON AUDITING PROCEDURE

Issued by the
COMMITTEE ON AUDITING PROCEDURE,
AMERICAN INSTITUTE OF ACCOUNTANTS,
270 Madison Aveune, New York 16, N. Y.

No. 23 (Revised) December 1949

Clarification of Accountant's Report When Opinion is Omitted

The committee on auditing procedure of the American Institute of Accountants in December, 1947, issued Statements on Auditing Procedure No. 23, Clarification of Accountant's Report When Opinion Is Omitted, *in which it proposed an amendment to* Extensions of Auditing Procedure *designed to improve current reporting practices. Following the issuance of Statement No. 23, it became evident that there was considerable misunderstanding in the profession as to the objectives of the proposed amendment and its application in practice. Accordingly, the proposed amendment was revised in May, 1949, to explain more fully the committee's views on the subject. The amendment, as thus revised, was submitted to the annual meeting of the American Institute of Accountants in November, 1949, and was formally adopted.*

This statement is a revision of Statements on Auditing Procedure No. 23, incorporating the amendment as adopted by the membership. It supersedes the original Statement No. 23.

1. The presentation of financial statements on the stationery or in a report of an independent public accountant without a definitive expression clearly indicating the representations he is making as to their fairness tends to create uncertainties in the minds of those who do not have special information regarding the preparation of the financial statements. In such cases, these third parties have no basis for determining what inferences are warranted by the association of the accountant's name with the financial statements and may place undue reliance upon them.

2. Illustrative of the practices which frequently give rise to such uncertainties are the following:

(a) The presentation of financial statements on the stationery of the accountant without comment, opinion, or signature; or with the assertion that the statements are "for management purposes only."

(b) The omission of an expression of opinion or of a specific disclaimer of an opinion in a report of an accountant in which financial statements and comments on the scope of the audit are included.

3. In the first case it is not clear whether, by his silence, the accountant intends to express unequivocal satisfaction with the financial statements or whether he intends to disclaim any opinion at all. The assertion that the statements are "for management purposes only" leaves the reader in doubt as to whether it indicates a limitation on the scope of the audit examination, whether it merely designates the form in which fully-approved statements are presented, or whether it has some other signficance. In the second case, there is a review of the accountant's procedures, but it is not clear whether those procedures were sufficient to permit the expression of an opinion.

4. Since the accountant cannot effectively control the use to which financial statements accompanied by his name may be put, the adoption of practices which will minimize the possibilities of uncertainties and misinterpretations by third parties is obviously to the interest of all concerned and should aid in the avoidance of embarrassment and damage to the profession. The committee on auditing procedure, therefore, recommends that, whenever financial statements appear on the stationery or in a report of an independent certified public accountant, there should be a clear-cut indication of the character of the examination, if any, made by the accountant in relation to the statements, and either an expression of opinion regarding the statements, taken as a whole, or an assertion to the effect that such an opinion cannot be expressed. When the accountant is unable to express an over-all opinion, the reasons therefor should be stated. When the accountant considers it appropriate to comment further regarding compliance of the statements with generally accepted accounting principles in respects other than those which require the denial of an over-all opinion, he should be careful to indicate clearly the limitations of such comments.

* * * * * *

5. On September 19, 1939, the membership of the American Institute of Accountants

approved a report of this committee entitled *Extensions of Auditing Procedure* which stated, in part:

"The independent certified public accountant should not express the opinion that financial statements present fairly the position of the company and the results of its operations, in conformity with generally accepted accounting principles, when his exceptions are such as to negative the opinion, or when the examination has been less in scope than he considers necessary. In such circumstances, the independent certified public accountant should limit his report to a statement of his findings and, if appropriate, his reasons for omitting an expression of opinion."

6. The views now being enunciated by the committee entail the modification and extension of this position. It is, therefore, recommended that the above-quoted paragraph, which appears on page 5 of Statements on Auditing Procedure No. 1, *Extensions of Auditing Procedure*, be amended to read as follows:

"The independent certified public accountant should not express the opinion that financial statements present fairly the position of the company and the results of its operations, in conformity with generally accepted accounting principles, when his exceptions are such as to negative the opinion, or when the examination has been less in scope than he considers necessary to express an opinion on the statements taken as a whole. In such circumstances, the independent certified public accountant should state that he is not in a position to express an opinion on the financial statements taken as a whole and should indicate clearly his reasons therefor. To the extent the scope of his examination and the findings thereof justify, he may also comment further as to compliance of the statements with generally accepted accounting principles in respects other than those which require the denial of an opinion on the over-all fairness of the financial statements. The purpose of these assertions by the accountant is to indicate clearly the degree of responsibility he is taking.

"Whenever the accountant permits his name to be associated with financial statements, he should determine whether, in the particular circumstances, it is proper for him to (1) express an unqualified opinion, or (2) express a qualified opinion, or (3) disclaim an opinion on the statements taken as a whole. Thus, when an unqualified opinion cannot be expressed, the accountant must weigh the qualifications or exceptions to determine their significance. If they are not such as to negative the opinion, a properly qualified opinion would be satisfactory; if they are such as to negative an opinion on the statements taken as a whole he should clearly disclaim such an opinion. His conclusions in this respect should be stated in writing either in an informal manner, as in a letter of transmittal bound with the financial statements, or in the more conventional short-form or long-form report. However, when financial statements prepared without audit are presented on the accountant's stationery without comment by the accountant, a warning, such as *Prepared from the Books Without Audit*, appearing prominently on each page of the financial statements is considered sufficient.

"It is not contemplated that the disclaimer of an opinion should assume a standardized form. Any expression which clearly states that an opinion has been withheld and gives the reasons why would be suitable for this purpose. However, it is not considered sufficient to state merely that certain auditing procedures were omitted, or that certain departures from generally accepted accounting principles were noted, without explaining their effect upon the accountant's opinion regarding the statements taken as a whole. It is incumbent upon the accountant, not upon the reader of his report, to evaluate these matters as they affect the significance of his examination and the fairness of the financial statements."

7. It should be remembered that *Extensions of Auditing Procedure* for 10 years has precluded the expression of any opinion on the financial statements taken as a whole when the accountant's exceptions or qualifications were such as to negative the opinion. That provision is continued under the amendment. The change is concerned solely with improving current reporting practices by providing that, in such cases, the accountant should henceforth clearly indicate that he is not in a position to express an opinion on the financial statements taken as a whole, and give his reasons why.

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ACCOUNTING PROBLEMS ARISING FROM DEVALUATION OF FOREIGN CURRENCIES

By Research Department,
American Institute of Accountants

This statement is issued by the research department to meet urgent requests for advice on certain problems arising from the recent widespread devaluations of foreign currencies. It reflects conclusions reached after extensive consultation with many leading accountants and corporate executives.

This memorandum is written for the purpose of commenting on some of the more important foreign exchange problems arising from the recent wholesale devaluation of currencies by some 25 countries in adjusting their respective monetary units downward in terms of the U. S. dollar. These problems are considered herein from the standpoint of expressing the accounts of foreign subsidiaries and branches in terms of U. S. dollars. Many of the problems may be resolved by following the principles stated in Accounting Research Bulletin No. 4. Others will require special attention.

A related problem of primary importance is whether to consolidate foreign subsidiaries and branches at all in view of the uncertain values which must be associated with the assets and liabilities, and the unrealistic statements of income which may result from the translation of many foreign currencies into dollars under existing conditions. With this in mind and in the light of the restrictions on the remittance of funds, which have existed and continue to exist in many countries, there may be many cases in which it will be desirable to exclude certain foreign subsidiaries and branches from consolidated financial statements.

Previous Recommendations

Whether consolidation of foreign subsidiaries is decided upon or not, adequate disclosure of foreign operations should be made. Four methods of presentation suggested by the committee on accounting procedure in 1939 in Accounting Research Bulletin No. 4 are worth repeating:

"(a) To exclude foreign subsidiaries from consolidation and to furnish: (1) statements in which only domestic subsidiaries would be consolidated; and (2) as to foreign subsidiaries, a summary in suitable form of their assets and liabilities, their income and losses for the year, and the parent company's equity therein. The aggregate amount of investments in foreign subsidiaries should be shown separately, and the basis on which the amount was arrived at should be stated. If these investments include any amount of surplus of foreign subsidiaries and such surplus had previously been included in consolidated surplus, the amount should be separately shown or earmarked in stating the consolidated surplus in the statements here suggested. The exclusion of foreign subsidiaries from consolidation does not make it permissible to include intercompany profits which would be eliminated if such subsidiaries were consolidated.

"(b) To consolidate domestic and foreign subsidiaries as hitherto, and to furnish in addition the summary described in (a) (2) above.

"(c) To furnish: (1) complete consolidated statements, and also (2) consolidated statements for domestic companies only.

"(d) To consolidate domestic and foreign subsidiaries as hitherto, and to furnish in addition parent company statements showing investment in and income from foreign subsidiaries separate from those of domestic subsidiaries."

In general, the underlying principles for stating the results of business conducted in foreign currencies were stated in 1931 by the special committee on accounting procedure as follows:

"Balance-Sheet

"Fixed assets should be converted into dollars at the rates prevailing when such assets were acquired or constructed. Where large units are purchased for Americaan dollars the American dollar cost will, of course, be used. If, however, the purchase is made in some foreign currency then the cost of the fixed assets should be the equivalent of the amount of foreign currency in American dollars, at the rates of exchange prevailing at the time payment is made. In consolidated accounts, the depreciation charged on fixed assets should be kept strictly on the American dollar cost, even though for purposes of local taxation it may be impossible to show the full currency equivalent on the foreign statements. . . .

"Cash, accounts receivable and other miscellaneous current assets should be converted at the rate of exchange prevailing on the date of the balance-sheet, unless protected by forward exchange contracts.

"Inventory should follow the standard rule of market or cost, whichever is lower in dollars. Where accounts are to be stated in which the question of foreign exchange enters and the inventory is not treated as an ordinary current asset and converted at the rate of exchange prevailing on the date

of the balance-sheet, the burden of proof should be on the client." *

"There are, however, undoubtedly many cases where the cost or a portion of the cost of an article was incurred when the foreign currency was at a substantially higher rate of exchange than existed on the closing day of the financial period. In many cases such an asset could not be replaced for the amount in currency at which it appeared in the records of the local branch or subsidiary company. In some cases the market price in currency would undoubtedly have been increased since the fall in exchange, and it would be inequitable to treat 'the lower of market or cost' as a mere conversion at the closing rate of the currency cost price, where the article could now be replaced only at a much higher amount in currency. Where the market price obtainable in dollars, after deducting a reasonable percentage to cover selling and other local expenses, exceeds the cost price of the article in dollars at the rate prevailing as of the date of purchase, such original dollar equivalent may be considered as the cost price for purposes of inventory.

"Current liabilities payable in foreign currency should be converted into dollars at the rate of exchange in force on the date of the balance-sheet.

"Long-term liabilities should not be converted at the closing rate, but at the rate of exchange prevailing when the liability was actually contracted. This is a general rule, but exceptions might exist in particular cases: for example, where there are assets receivable over a term of years, which are converted at the current rate, particularly where such assets could be applied to the retirement of such liabilities.

"As a case in point, assume a corporation had a series of bonds to be retired in ten equal annual payments in currency and corresponding receipts from assets sold on the deferred-payment system, falling due at or about the same time as the payments due to the bondholders, then such offsetting items might reasonably be carried at the same rate of exchange.

"PROFIT-AND-LOSS STATEMENT

"A loss arising through a fall in foreign exchange is a risk incidental to foreign business, and should be a charge to operating accounts and not a charge to surplus; however, in such a year as the present, the item will be a substantial one in many cases and may be stated separately in the published accounts of a business, if so desired. All businesses engaged in foreign trade have what may be considered normal exchange differences which would properly be included under the ordinary captions. It is probably impossible to formulate an absolute general rule to cover the determination of the amount of special loss on foreign exchange during such financial periods as are now closing.

"Where a loss could be considered as occurring to a large extent within two or three days through the country in which business is being conducted suspending or abandoning the gold standard, a fair measure of the loss might be taken by calculating the fall in the dollar equivalent on the net current assets carried in such depreciated currency, as outlined above. In other cases, the special loss may fairly be determined by a similar calculation at the end of the fiscal period, but in this case an adjustment may be desirable if remittances from currency to dollars have been markedly below or in excess of the normal operations subsequent to such fall in exchange.

"Where a definite loss could not be established, a figure based on the average expense which has been incurred through exchange during recent periods might be considered as a fair charge to usual or normal operations, and the remainder of the loss on exchange for the entire financial period treated as the special loss.

"In cases of foreign branches or subsidiaries, corporations conducting their business in foreign currencies, (buying, selling and manufacturing) operating statements should be converted preferably on the average rate of exchange applicable to each month, where there have been wide fluctuations in exchange or if this will involve too much labor on a carefully weighted average."

In addition, certain statements by the committee in 1939 should be emphasized:

"As to earnings, a safe rule for United States companies to follow would be that in their own accounts earnings from foreign operations for the current year should be shown only to the extent that actual remittances for them had been received in the United States. Provision should be made also for known losses of subsidiaries. In other words, the position shown should not be made better by the omission of foreign results.

"Any earnings to be reported beyond the amounts already received in the United States should be carefully considered in the light of all the facts. The amounts should be disclosed if they are significant and they should be reserved against to the extent that their realization in dollars may be doubtful. . . .

"Where the corporation's practice is to carry the balance of income to a separate

* Possibly emphasis should be placed on *those who wish to follow some other procedure* rather than on *the client.*

surplus statement, either (1) the provision should appear as a charge in the income statement . . . or (2) if the amount and the circumstances are such that this would seriously impair the value of the income statement as an indication of earning capacity, and the charge for that reason is made to surplus, a clear disclosure of the treatment should appear in a note in the income statement."

Further Recommendations

Losses from Devaluation

In considering the last quotation, it should be noted that the committee on accounting procedure in Accounting Research Bulletin No. 32 emphasized that only when charges of the type described therein are material in the aggregate in relation to the company's net income, do they upset the general presumption that all items of profit and loss should be used in determining net income. While the possibility of losses from currency devaluation may ordinarily be considered to be a risk inherent in the conduct of business in foreign countries, the world-wide scope and unprecedented magnitude of the recent devaluations of foreign currencies are such that they cannot be considered recurrent hazards of business. Accordingly, the losses resulting from such devaluation would appear to be of such a nature that, if they are so material in amount that their inclusion in the income statement would impair the signficance of net income to an extent that misleading inferences might be drawn therefrom, they might appropriately be charged to retained income (surplus) under the provisions of Bulletin No. 32.

Operations

In many cases it may be desirable to follow the recommendations of Bulletin No. 4, which would result in the application of both pre- and post-devaluation rates to the operations of a single year. There may, however, be situations in which more realistic results would be obtained if income computed in foreign currencies were to be translated for the entire fiscal year at the post-devaluation rates. This procedure would have the practical advantage of making it unnecessary to cut off at the date of the devaluation. Where dividends have been paid prior to the devaluation date, out of earnings of the current fiscal year, that portion of the income for the year should be considered as having been earned at the pre-devaluation rate irrespective of the rate that may be used in translating the remainder of the earnings accumulated prior to the devaluation date.

There may be cases in which the income statement would present very misleading results if the pre-devaluation exchange rates were used for a large part of the fiscal year, and the loss resulting from the fall in exchange rates were charged to retained income (surplus). Obviously, the charge to income for the fall in exchange should not be less than the loss applicable to the increase in net current assets since the beginning of the fiscal year during which devaluation took place.

Fixed Assets

Generally, the rule for translation of fixed assets at rates in effect when the asset was acquired or constructed should be followed. One exception to the rule might be with respect to current plant additions when income is translated at post-devaluation rates. Another exception might be with respect to fixed assets acquired with foreign capital, to which reference is made later. When, however, fixed assets are purchased with United States dollars, or when they are purchased in foreign currencies presumably out of profits which are not restricted as to withdrawal, the United States dollar cost or the dollar equivalent of the foreign currency at the date of purchase should be recognized as the amount at which such assets should be carried.

Long-term Liabilities

Translation of long-term liabilities presents possibly the greatest deviation from the principles previously stated by the committee. The committee generally has favored translating long-term liabilities at the rates of exchange prevailing when the liability was actually contracted, but recognized that there were exceptions. The purpose was to avoid giving recognition to minor fluctuations in foreign currencies. The argument has been advanced, however, and apparently without satsifactory rebuttal, that long-term bonds will be paid off in post-devaluation currencies and therefore should be translated at post-devaluation rates. This argument may not be compelling in any given instance, but the logic supporting it is convincing for a fall in rates of the breadth and size of the one just witnessed. Accordingly, with respect to long-term bonds, the general rule should be modified to permit translation at post-devaluation rates.

Under certain circumstances, the gain resulting from restating the long-term debt at the lower rates of exchange may appropriately be offset against the loss arising from translation of net current assets. However, when fixed assets held in the foreign country were acquired with funds obtained in that country, it may be appropriate to restate the fixed assets to the extent of the reduction of the related debt.

Capital Stock

Consideration also should be given to the rates at which capital stocks stated in foreign currencies are to be translated; whether they

should be translated at historical rates, or at the average of rates applicable to the net assets, or at the post-devaluation rates, would depend on the circumstances in the individual cases.

* * * *

In conclusion, the underlying principles as stated in Accounting Research Bulletin No. 4 and the interpretation and modification suggested in this statement are intended only as guides to those confronted with current and unusual foreign exchange problems resulting from devaluation of foreign currencies. Each problem will have to be resolved according to the best judgment of those responsible for making the decisions, having due regard for the facts and the general rules.

November, 1949

A Simplified Financial Budget for Smaller Manufacturers

(Continued from page 36)

ing December, January, February and March, and would be able to pay off his loans by April. The amount of loans required may be gauged by providing enough additional funds to overcome the anticipated deficiency and also to provide a minimum cash balance.

The most interesting aspect of the budget is that it is a future projection and not a mere record of past history. By its very nature the budget becomes a living tool. Each month the actual and budgeted figures should be compared. If the variations are pronounced, revisions in policy should be arranged and corresponding modifications should be made in the budget for the remainder of the season. The budget thus fosters prompt action by management and helps develop an attitude of creative planning.

Budget installation and maintenance is practical, and invariably justifies the time and energy required. However, some accountants oppose the adoption of budgetary procedures or of any extension of their usual services because of an understandable concern with the problem of additional compensation for their extra work. Experience indicates that hard-headed management is willing to pay for practical services. A properly administered budget can become a dynamic operating guidepost which will be utilized constantly by the management. It should be noted also, that in some instances budgetary projections may reveal the impossibility of profitable operations, in which case both client and accountant may be guided constructively by such knowledge.

Because of his interesting combined roles of independent auditor and management consultant, the certified public accountant serving the smaller manufacturing firms has a unique opportunity to encourage the adoption of more modern procedures for managerial control over business operations. As a result of the joint efforts of the accounting and credit professions, great strides have been made in recent years in the extension of accounting services. It is now standard procedure in certain industries for certified public accountants to make periodic audits and to issue independently certified financial statements. The adoption of formal budget procedures is another progressive development which the business community will welcome if management's financial advisors become its enthusiastic sponsors. In some cases it may require a pioneering spirit to install formal budget procedures for the smaller manufacturer but the accountant who leads the way will render a substantial service not only to his client but to the business community and to his profession as well.

CORRESPONDENCE

To the Editor of *The New York Certified Public Accountant:*

Reference is made to the article entitled "Accountants' Report Concerning Financially Embarrassed Debtors" by Saul C. Hertz, C.P.A., which appeared in the July, 1949, issue. Mr. Hertz has treated the subject very thoroughly. But at the same time, his article is provocative.

The author has classified the types of accountants' reports into three categories as follows:

1. Reports prepared by the accountant for the debtor.
2. Reports prepared by the accountant selected by a committee of creditors.
3. Reports prepared by the accountant appointed by a trustee in bankruptcy.

He then proceeds to indicate the type and contents of a report to be submitted for each of the above categories.

In situations one and two above, it is recognized that there is somewhat of a difference surrounding the circumstances regarding the selection of the accountant. However, there does not appear to be any reasonable basis for a difference in either the type of report or the purpose which it will serve. We must certainly assume that the accountants in either case would be equally competent and thorough in their work. It necessarily follows that an accountant engaged by the debtor, with full knowledge of the purpose of his report should include all the information that an accountant engaged by the creditor would submit. It is conceded that the accountant selected by the creditor might be engaged for a specific purpose, such as rendering his own thoughts on why the company has experienced difficulty; nevertheless the financial reports, *per se,* should be virtually the same, after accounting for elapsed time between the last report and the current one.

Going a step further, it would also appear that the reports suggested by Mr. Hertz are somewhat overburdened with superfluous schedules. Many of the schedules recommended by the author are normally part of the accountant's work papers and represent nothing more than having them typed. Would it not be better to exclude such schedules from the report itself, but have the work papers available for presentation if desired by the committee of creditors?

Mr. Hertz also states that ". . . during the period of investigation and negotiation, it behooves the accountant to preserve and augment the assets of the debtor." It is not readily apparent as to what he means by that statement. Does Mr. Hertz imply that the accountant will take over control and management of the debtor's affairs? This would rarely be the case. He also states that the accountant should disclose ". . . any irregularities discovered, which would include concealment of assets, fraudulent transfer, . . .". Does he mean to say that he does not have faith in the report of an independent accountant merely because the accountant was engaged by the debtor? Is it not the duty of an accountant rendering an opinion as to the financial statements to disclose such irregularities or not render an opinion and indicate the reason? To believe otherwise does not speak highly for other practitioners or the profession as a whole.

Mr. Hertz, in the last paragraph of his second category states, ". . . the accountant for the creditors might find it beneficial to submit a forecast of operations as well as a financial forecast or

budget. This would require a careful projection of future sales, purchases, expenses and manufacturing costs. . . ." How does the author expect to render an opinion with respect to such a forecast? The very nature of such a financial statement precludes the verification of any of the items pertinent thereto. Certainly an accountant can not satisfy himself as to the accuracy of such a financial statement within the dictates of accepted auditing procedure. If he took exception to such a statement, but nevertheless included it as a part of a report wherein he rendered an opinion as to the other financial statements, his qualifications and exceptions would certainly have to be very strong. Rule 6 of the Rules of Professional Conduct of the New York State Society of Certified Public Accountants states:

> "A member shall not permit his name to be used in conjunction with an estimate of earnings contingent upon future transactions in a manner which may lead to the belief that the member vouches for the accuracy of the forecast."

However, as an alternate procedure, the accountant might prepare himself to submit such information in oral form at a meeting or a conference. He could then indicate to all concerned, in no uncertain terms, that such figures are purely estimates, prepared from the best available information, but that he can form no opinion as to their accuracy.

It is hoped that this will be published so that other opinions may be expressed on the matter.

Very truly yours,

JEROME G. FUTERMAN
GEORGE V. DELSON

New York, N. Y.
November 4, 1949.

Rejoinder by Mr. Hertz:

May I express my appreciation to Messrs. Jerome G. Futerman and George V. Delson for their letter regarding my article in the July, 1949, issue of the New York Certified Public Accountant, entitled, "Accountants' Reports Concerning Financially Embarrassed Debtors."

To the general practitioner, there apparently seems to be no discernible difference in the kinds of reports, nor would he be much concerned as to whom he would represent, having only one standard to pursue and that is sincerity of purpose, honesty and thoroughness in his professional work. However, the specialist, whose practice is devoted to this work, has been taught by experience to indulge in fine distinctions and developed procedures and methods of presentation which, naturally, may not be gleaned from an occasional assignment.

Secondly, my correspondents state that my recommendations and suggestions would entail too voluminous a report, overburdened with "superfluous schedules." They feel that since the schedules which I have enumerated are contained in "the work papers available for presentation if desired by the committee of creditors", there is no need to burden the report therewith. I sincerely feel that if a report is rendered, it should be complete in every detail, regardless of the space it occupies. For that matter, if the recommendations offered were pursued, no report would have to be rendered, and only the working papers would need to be presented to the committee. However, here again, experience has shown that these committees work from the accountant's report and use it assiduously in liquidating assets. The omission of any schedule which should be part of the report, such as a schedule of accounts receivable, would be as irritating as an omission of a statement of affairs or any other important schedule. For example, the schedule of accounts receivable might be quite voluminous and, in that event, could be embodied into a supplemental report; but the fact is that such schedule should be rendered to the committee of creditors or to the trustee in bankruptcy.

I might say that my correspondents may take me too literally in the accountant's endeavor to preserve or augment the assets of the debtor. Naturally, any professional man should achieve those ends. Surely, if the accountant represents an estate and finds that the executor makes bad investments, it is not only his duty, but it becomes necessary for him, through advice and counsel, to guide him to the proper path.

Far be it from me to accuse any practitioner, or the profession as a whole, of failing to disclose irregularities in the operations of a business when rendering reports. But the fact is that, regardless of the character and reputation of the accountant preparing a report for the debtor, where creditors have sustained financial losses, it has been a common practice for them to investigate the debtor's affairs by independent accountants of their own choosing. As a matter of fact, whether it is approved by accountants or not, demands are frequently made for a choice of accountant satisfactory to the investigator who may not be the same as the accountant for the debtor.

I am sure my correspondents have had the experience, where an outside investor, interested in buying a share in a closed corporation, insisted on having an independent audit made by his own accountants. I have had that experience on both sides, where I have rendered full reports and have had other accountants examine the books, in spite of my report; and I have also been called in to represent an investor to examine the books and records and report rendered by other accountants. Although the accountants in the above instances were reputable and qualified, there were numerous differences of opinion as to the net results, both as to net profits and net worth and other figures in the reports.

My correspondents also find an objection to my suggestion in advocating forecasts, and imply the unethical feature of the accountant doing so. In connection with the submission of financial and operating forecasts, the creditors and the debtor frequently agree to an extension of time which may take anywhere from six months to several years, in which the debtor is to meet his past due obligations. It would only be natural for creditors to request a plan as to whether future operations of the debtor would be sufficient to keep the business going and, at the same time, provide sufficient "surplus" to liquidate the deferred debt. There is no doubt about the fact that the accountant who prepares such a forecast would have to qualify it and not render an "opinion" in connection therewith. But, it seems to me that it is a common practice for accountants to counsel and aid their clients in forecasting the operations of the company, its cash requirements, and the like. Moreover, it is an important function of the accountant to assist solvent, going companies with periodic forecasts. I am, therefore, very much at loss to understand where my correspondents have found any infraction of the rules of professional conduct when there is a great deal of literature on this subject and, when in our Society, we have a committee on budgets.

Let me again thank my correspondents for the privilege of receiving their criticisms and the opportunity to reply to them.

Very truly yours,

SAUL C. HERTZ

BOOK REVIEWS

Buying and Administering Corporate Insurance

By Russell B. Gallagher. Published as Research Report Number 15 by American Management Association, New York, N. Y., 1949. Pages: 123; $2.50 members; $3.75 non-members.

This report is a pioneer in the new highly specialized field of insurance administration; it is intended to guide the executive who is charged with the responsibility of ascertaining the nature of business exposures and for determining the extent to which insurance coverage is indicated, and who must then proceed to place the required insurance. The exposures discussed in this monograph are: fire, casualty and catastrophe, and do not include such recent innovations in the field as pensions, disability and group insurance requirements.

The subject matter of the report may be subdivided for convenience into three sections. The first includes a discussion of the policies to be determined at the top level as to the extent to which insurance coverage is to be purchased, and the extent to which risks are to be assumed by the company.

The second (and most extensive section) is intended to serve as a guide to the person charged with the administration of insurance matters. There is included here a select group of forms and related data which would be most helpful to the administrator in determining the amount of insurance required, placing insurance, following-up and maintaining insurance coverage, determining and adjusting of losses and in the reporting to management of the results of insurance administration.

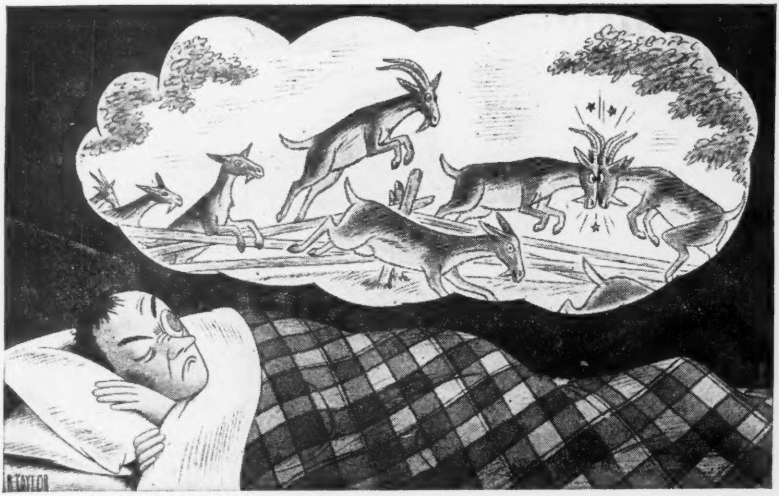
The third section includes suggestions for integrating the work of the insurance administrator (or insurance department) with the work of accounting, plant protection, tax, legal, real estate, purchasing and personnel departments. It is noted that close liaison is essential if the functions of the insurance administrator are to be fulfilled effectively without duplication and waste.

There are also included (as appendices) the data obtained by the American Management Association from its comprehensive survey of 226 representative companies in manufacturing, utility and financial enterprises.

The monograph is undoubtedly required reading for an insurance executive and would be useful as reference material to anyone charged with the responsibility of purchasing insurance and who would like to do more than turn the problem over to a broker.

Abraham J. Briloff

New York, N. Y.



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